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Panel on Financial Affairs
Special meeting on 14 December 2009

Background brief on depreciation allowances in respect of machinery or plant under "import processing" arrangement

Purpose

This paper sets out the background to the enactment of provisions of the Inland Revenue Ordinance (Cap. 112) (the Ordinance) which limit the granting of initial and annual allowances (depreciation allowances) for profits tax in respect of leased machinery or plant. It also summarizes the views and concerns expressed by Members at meetings of the Legislative Council (LegCo) and the Panel on Financial Affairs (FA Panel).

Background

2. Section 39E of the Ordinance was enacted in 1986 and amended in 1992. According to the Administration, the legislation aims at limiting tax avoidance opportunities in various forms of machinery or plant leasing arrangements. As many of such tax avoidance arrangements involve machinery or plant owned by a Hong Kong enterprise being used by an enterprise outside Hong Kong for a long period of time, section 39E stipulates that the Hong Kong enterprise will not be granted depreciation allowances for the relevant machinery or plant under such circumstances. According to the Administration's explanation to Members in 1992 during the scrutiny of the proposed amendment to section 39E, the provision is not intended to have any impact on normal commercial leasing transactions. If a Hong Kong enterprise leases its machinery or plant to another enterprise outside Hong Kong through a normal leasing arrangement, although the Hong Kong enterprise concerned will not be granted depreciation allowances for the relevant machinery or plant, its rental income derived from outside Hong Kong will not be subject to Hong Kong tax.

3. The Inland Revenue Department (IRD) issues departmental interpretation and practice notes (DIPN) to provide detailed explanations and realistic examples to facilitate taxpayers' understanding of and compliance with the relevant provisions of

the Ordinance. The interpretation and practices in relation to section 39E is provided in DIPN No. 15, which was issued by IRD in 1986 and was last revised in 2006. The relevant extract of DIPN No. 15 is at **Appendix**. According to IRD's interpretation in the DIPN, section 39E was enacted to limit the opportunities for tax deferral or avoidance through sale and leaseback, offshore equipment leasing and leveraged leasing arrangements.

Views and concerns expressed by Members and the Administration's response

4. Members have expressed concern about the interpretation and application of section 39E of the Ordinance at meetings of the FA Panel on 6 April 2009 and 15 October 2009. Members highlighted the concerns of the business and professional sectors about the existing provision under section 39E of the Ordinance in which depreciation allowances would not be granted for leased machinery or plant used wholly or principally outside Hong Kong. Given the business integration between Hong Kong and the Mainland, Members were concerned about the need for a critical review of the taxation legislation to cope with the changing circumstances.

5. At the Council meeting on 21 October 2009, Dr Hon LAM Tai-fai asked a question on taxation in relation to leasing arrangements, expressing his concern about the denial of depreciation allowances, under the existing section 39E and the revised DIPN No. 15, for Hong Kong enterprises making the machinery and plants available for use by factories or their outsourced manufacturers on the Mainland under general commercial arrangements such as import processing arrangement. At the Council meetings on 4, 25 November and 9 December 2009, Dr LAM asked further questions on section 39E of the Ordinance to follow up his concern and the Administration's replies on the subject.

6. The Administration explained that there are practical difficulties in relaxing the restrictions on "being used outside Hong Kong" under section 39E. Although the taxpayer has the onus of proof under the Ordinance, as the relevant machinery or plants are used by another enterprise outside Hong Kong and such an enterprise is usually a separate legal entity, it would be difficult for IRD to check the actual usage of the relevant machinery or plants. Besides, IRD does not have the statutory power to request such an overseas entity to provide supporting documents. If the relevant restriction is relaxed, the specific anti-avoidance provision can easily be exploited, resulting in tax deferral or loss and a large number of cases in dispute.

Latest development

7. The FA Panel will discuss the subject of depreciation allowances in respect of machinery or plant under "import processing" arrangement at the special meeting on 14 December 2009. The Administration, and relevant trade and professional organizations are invited to attend the meeting for discussion of the subject.

Relevant papers

8. The relevant papers are available at the following links:

Minutes of FA Panel meeting on 6 April 2009 (paragraphs 13 to 14)
http://www.legco.gov.hk/yr08-09/english/panels/fa/minutes/fa20090406.pdf

Minutes of FA Panel meeting on 15 October 2009 (paragraphs 10 to 11)
http://www.legco.gov.hk/yr09-10/english/panels/fa/minutes/fa20091015.pdf

Dr Hon LAM Tai-fai's question on taxation in relation to leasing arrangements at LegCo meeting on 21 October 2009
http://www.info.gov.hk/gia/general/200910/21/P200910210125.htm

Dr Hon LAM Tai-fai's question on section 39E of the Ordinance at LegCo meeting on 4 November 2009
http://www.info.gov.hk/gia/general/200911/04/P200911040188.htm

Dr Hon LAM Tai-fai's question on section 39E of the Ordinance at LegCo meeting on 25 November 2009
http://www.info.gov.hk/gia/general/200911/25/P200911250162.htm

Dr Hon LAM Tai-fai's question on section 39E of the Ordinance at LegCo meeting on 9 December 2009
http://www.info.gov.hk/gia/general/200912/09/P200912090138.htm

DIPN No. 15 issued by the Commissioner of Inland Revenue
http://www.ird.gov.hk/eng/pdf/e_dipn15.pdf

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4. A limited partner cannot claim a loss set-off in excess of the "relevant sum", which is the amount of his contribution to the partnership as at the end of the relevant year of assessment in which the loss is sustained. If the person ceased to be a partner in the partnership during that year of assessment the appropriate time is the time when he so ceased.

5. The loss set-off of a limited partner is restricted to the lesser of:

(a) his share of the partnership loss; or

(b) the relevant sum.

6. Any loss not set off is carried forward in the partnership and set off against future assessable profits of the partnership. They are not available for set-off against other assessable profits which the limited partner may have in subsequent years.

7. In applying the provisions it is necessary to ascertain the amount of the limited partner's contribution to the partnership. This is the aggregate of the amounts of capital contributed to the partnership and not withdrawn, whether directly or indirectly, or otherwise received back, and any profits or gains which have not been withdrawn from the partnership, whether in money or money's worth. Anything which the limited partner is, or may be, entitled to draw out, receive back, or be reimbursed from another person at any time whilst the partnership carries on the trade, profession or business must be deducted.

PART B - LEASING ARRANGEMENTS (SECTION 39E)

The position in general

8. Section 39E was enacted to limit the opportunities for tax deferral or avoidance through sale and leaseback, offshore equipment leasing and leveraged leasing arrangements. In broad terms section 39E operates to deny to a lessor (owner) initial and annual allowances ("depreciation allowances") in respect of any machinery or plant owned by him where a person holds rights as lessee under a lease of the machinery or plant and:

(a) the machinery or plant was previously owned and used by the lessee or his associate (i.e. a sale and leaseback arrangement), or

(b) the machinery or plant, other than a ship or aircraft or any part thereof, is while the lease is in force:

(i) used wholly or principally outside Hong Kong by a person other than the lessor; or

(ii) the whole or a predominant part of its cost of acquisition or construction was financed directly or indirectly by a non-recourse debt (i.e. a leveraged lease arrangement); or

(c) the machinery or plant is a ship or aircraft or any part thereof and:

(i) the lessee is not an operator of a Hong Kong ship or aircraft; or

(ii) the whole or a predominant part of its cost of acquisition or construction or the part thereof was financed directly or indirectly by a non-recourse debt.

The lease

9. Under section 2 of the Ordinance, lease in relation to any machinery or plant includes:

(a) any arrangement under which a right to use it is granted by the owner to another person; and

(b) any arrangement under which a right to use it, being a right derived directly or indirectly from a right referred to in paragraph (a), is granted by a person to another person,

but does not include a hire-purchase agreement or a conditional sale agreement unless the Commissioner considers that the right under the agreement to purchase or obtain the property in the goods would reasonably be expected not to be exercised.

Party identification

10. In general the reference to "taxpayer" in section 39E connotes the lessor (owner) who has incurred capital expenditure on the provision of the machinery or plant being leased. The party which ultimately uses the machinery or plant is described as the "end-user", who is either:

(a) the lessee, either alone or with others, or

(b) an "associate" of the lessee.

For this purpose the term "associate" has been defined widely in section 39E(5) in order to prevent circumvention of the provision by the interposition of third parties.

Sale and leaseback

11. Denial of depreciation allowances in section 39E(1)(a) is intended to prevent an overall tax benefit being obtained through the sale and leaseback of machinery or plant.

12. Section 39E(1)(a) refers to leased machinery or plant which at any time prior to its acquisition by the lessor was owned and used by the end-user. "Owned" is not defined but is a word of common usage and in practice will be given its ordinary meaning. "Used" is defined to include "held for use" meaning installed ready for use or held in reserve. The term "ready" denotes a condition of functional operability.

13. Section 39E(2) provides an exception to the general rule that no initial or annual allowances will be granted in respect of machinery or plant acquired under a sale and leaseback arrangement. This exception applies in the situation where:

(a) a lessor purchases machinery or plant from an end-user at a price not greater than the price paid to the supplier (being a supplier who is not an end-user) by the end-user; and

(b) no initial or annual allowances have been made to the end-user in respect of that machinery or plant prior to its acquisition by the lessor.

Example 1

Company L is a leasing company whereas Company A is a manufacturing company. Both companies are carrying on business in Hong Kong. Under a sale and leaseback arrangement, Company A after revaluing its old machinery and plant sold them to Company L. Company L in turn leased the machinery and plant back to Company A for rental. Before the arrangement, depreciation allowances on the machinery and plant were made to Company A.

Company L would be denied depreciation allowances in respect of the machinery and plant under section 39E(1)(a) because they were owned and used by Company A prior to acquisition. The exception in section 39E(2) did not apply because depreciation allowances were previously granted to Company A.

Example 2

Company B purchased machinery of $100 million. Before putting them into use and claiming any depreciation allowances, Company B sold to and leased back from Company L the machinery. Under the sale and leaseback arrangement, Company B obtained cash proceeds of $100 million which was the price he paid the supplier and was required to pay a rental of $11 million for a consecutive period of ten years. Assuming each instalment contained an effective finance charge of $1 million whereas the market interest should have been $2 million, Company B in effect transferred the depreciation allowances to Company L in return for a lower rate of interest. Company B after receiving the cash of $100 million applied the money for other commercial transactions to produce chargeable profits.

The conditions in section 39E(2) are satisfied. Company L would not be denied depreciation allowances. Company B in effect made use of the sale and leaseback arrangement to obtain cheaper finance for its business use. Company L, the lessor, had in effect committed capital into the machinery, incurring genuine commercial risk. The whole arrangement is a normal commercial transaction.

14. Because entitlement to these allowances is mandatory upon acquisition of machinery or plant, in order for the exception in paragraph 13 to apply it will be necessary for the end-user to submit a disclaimer to the Commissioner in writing within 3 months of the date on which the machinery or plant was acquired, or within such further period as the Commissioner may permit. Generally, the Department will not entertain requests for an extension of the 3 months disclaimer period. A notice of disclaimer should be accompanied by the following information:

(a) a description of the relevant asset;

(b) the name and address of the supplier;

(c) the date of purchase from and price paid to the supplier;

(d) the date of sale to and price paid by the lessor; and

(e) the name and address of the lessor.

The above information must be supported by copies of purchase and sale agreements or invoices and the lease agreement.

15. After submitting notice of a disclaimer, the end-user might decide to retain the right to claim depreciation allowances and seek to cancel the sale and leaseback arrangement. As a concession, the Department is prepared to allow the withdrawal of a disclaimer, provided that the relevant assessment has not yet become final and conclusive.

Used wholly or principally outside Hong Kong

16. The "used wholly or principally outside Hong Kong" condition in section 39E(1)(b)(i) aims to encourage the generation of economic benefits in Hong Kong by the use of the machinery or plant in Hong Kong.

17. The question whether a particular item of machinery or plant is used "wholly or principally" outside Hong Kong is a question of fact to be decided having regard to the circumstances of the case. The following matters are, however, likely to be relevant in determining the issue:

(a) the place where the asset is physically located and put to use or held for use;

(b) the nature of the asset;

(c) the nature of the end-user's business;

(d) the locality in which the asset is, under the terms of the lease, designated for use throughout the period of the lease.

Example 3

Company L is a leasing company carrying on business in Hong Kong. Company C is an enterprise carrying on business in Mainland China. Company L leased its machinery to Company C for rental.

Company L would be denied depreciation allowances in respect of the machinery under section 39E(1)(b)(i) because the machinery was used wholly outside Hong Kong. It should be noted that no deduction would be given under section 16G because the machinery under a lease is an "excluded fixed asset" as defined in section 16G(6). As a practice, the rental income accrued to Company L from leasing the machinery would be regarded as non-taxable.

18. No doubt cases will arise where leased machinery or plant will be used, either in one year, or, over a period of years, both within and outside Hong Kong. In these cases the Department will look at each leased asset and each year of assessment separately. If in a particular year the machinery or plant is used wholly or principally in Hong Kong then the prescribed depreciation allowances will be granted. On the other hand, if in a particular year the machinery or plant is not used wholly or principally in Hong Kong then no allowances will be granted. For the purposes of determining the written down value of the item to be carried forward, the notional amount of allowances which would have been granted had the item been used in Hong

Kong will be deducted from the written down value brought forward. Any balancing adjustments on the sale of the item will be calculated on a pro-rata basis.

19. Under a contract processing arrangement with a Mainland Chinese enterprise, a Hong Kong company is often required to provide machinery or plant for the use of the Mainland Chinese enterprise. Such arrangement is a lease as defined in section 2 (see paragraph 9) and therefore section 39E needs to be considered. Even though the machinery or plant is not used wholly or principally in Hong Kong, the Department as a concession is prepared to allow 50 per cent of the depreciation allowances on the leased machinery or plant on the condition that the profits from manufacturing activities of the Hong Kong company are assessed on a 50:50 basis. The concession however will not apply where the Hong Kong company has ceased to be owner of the machinery or plant. For example, the Hong Kong company will be denied depreciation allowances on the machinery or plant which are injected as its share of equity of a "foreign investment enterprise" ("FIE") in the Mainland, as such machinery or plant is owned by the FIE.

Example 4

Company D is carrying on a manufacturing business in Hong Kong. Under a contract processing arrangement with a Mainland Chinese enterprise, Company D is required to provide machinery and plant to the Mainland Chinese enterprise for the latter's processing work. Company D did not charge the Mainland Chinese enterprise any rental for the use of the machinery and plant.

Although no rental is charged, the arrangement is still a lease as defined in section 2. As the machinery or plant is under a lease, it is an "excluded fixed asset" under section 16G(6) and falls outside the purview of section 16G. Hence, no deduction under that section would be given. Strictly, Company D should be denied depreciation allowances in respect of the machinery and plant leased to the Mainland Chinese enterprise under section 39E(1)(b)(i). However, if the profits from the manufacturing activities of Company D are assessed on a 50:50 basis, the Department would be prepared to grant 50 per cent of the depreciation allowances as a concession.

Example 5

Company G is carrying on business in Hong Kong and is the holding company of Company H. Company H is a wholly owned foreign enterprise set up as a separate legal person in the Mainland. Company G purchased machinery and plant and injected them into Company H as its capital contribution in specie.

As a result of the capital contribution, Company G has ceased to be owner of the machinery and plant. In effect, Company G has sold the machinery and plant in return for its equity interest in Company H. The question of a lease does not arise. Thus Company G would not be entitled to any depreciation allowances.

Ships or aircraft

20. Where the asset is a leased ship or aircraft the law prescribes a different test for deciding whether initial or annual allowances shall be granted to the taxpayer (lessor) – see section 39E(1)(c). In such cases the question is not whether the ship or aircraft is used wholly or principally outside Hong Kong but whether the person holding rights as lessee (the end-user) is an operator of a Hong Kong ship or aircraft. An operator of a Hong Kong ship or aircraft is a person who carries on business as an operator of ships or aircraft being a business controlled and managed in Hong Kong and:

(a) in the case of an aircraft, holds an air operator's certificate issued under the Air Navigation (Hong Kong) Order 1995 (Cap. 448 sub. leg. C); or

(b) in the case of a ship, is responsible for meeting all, or a substantial portion of the operating expenses of the ship and the ship operates mainly in the waters of Hong Kong or between the waters of Hong Kong and waters within the river trade limits.

Leveraged leases

21. A leveraged lease arrangement, as it has become known to this Department, is typically one in which a partnership of companies acquires machinery or plant (generally ships or aircraft) which it leases for a term of

years to a lessee and where, by reason of the "leverage" obtained from the borrowing of a substantial non-recourse loan, the members of the partnership are effectively at risk for no more than a relatively small part of the funds used to acquire the asset. The lenders' security for the substantial amounts lent to acquire the asset is limited to the asset itself and/or by way of a charge over the lease and the related lease payments.

22. So far as it relates to leveraged leases, section 39E denies initial and annual allowances to a taxpayer (lessor) where the whole or a predominant part of the cost of machinery or plant was financed directly or indirectly by a non-recourse debt.

23. The term "non-recourse debt" is defined extensively in section 39E(5) but in broad terms means, as mentioned above, a method of financing where the borrower has no absolute liability in respect of the borrowing and in the event of default in repayment the rights of the lender are restricted to the asset itself or the income generated by it. For the purposes of this provision the Department will generally accept that where a taxpayer (lessor) actually contributes or is fully at risk for at least **51** per cent of the cost of the asset then the financing is not predominantly by a non-recourse debt and in such cases section 39E(1) will have no application.

PART C - GENERAL ANTI-AVOIDANCE PROVSION (SECTION 61)

The position in general

24. Section 61 empowers the Assessor to disregard certain transactions or dispositions and assess the taxpayer accordingly. This section is not a charging section, but serves to protect the liability for tax established under other sections of the Ordinance. This proposition is consistent with the dicta of Richardson J in *Challenge Corporation Limited [1986] 8 NZTC 5,001 [CA]* on the status of New Zealand's general anti-avoidance provision *(at page 5,019)*:

> "Section [the relevant general anti-avoidance provision] is not an independent charging provision. It does not itself create a liability for income tax; its function is to protect the liability for income tax established under other provisions of the legislation."

facts (i.e. facts have not been disclosed in the return, accounts or any statement submitted to the Department), it is likely to be a scheme of tax evasion rather than tax avoidance.

61. On the penalty aspect of tax avoidance cases, the Department takes the following views:

(a) Whether a certain tax avoidance scheme may be regarded as a tax evasion arrangement and be penalised as such depends on the availability of evidence to prove that the tax avoidance scheme was a sham set up for the purposes of tax evasion. No single factor may conclusively lead to such a conclusion. The wrongdoer would be penalised if there is sufficient admissible evidence to prove that the taxpayer and/or his tax advisor has committed an offence under section 80(2) or section 82 of the Ordinance;

(b) The provisions in section 61/61A and section 80(2)/82A are not mutually exclusive. As such, penalty actions can be invoked under section 80(2) or section 82A against the taxpayer concerned regardless of whether section 61 or section 61A has been applied to bring the profits/income in question into the tax net.

62. In considering whether any penalty action should be invoked, the facts and the circumstances of the particular case will be carefully examined. In general, the Department will impose penalty on the taxpayers if there were elements of dishonesty or fraudulence involving the use of artificial or fictitious devices, or where the transactions (e.g. expenditure claims) were false or unsubstantiated.

PART H - GUIDELINES ON LEASE FINANCING

Leases in general

63. Following the enactment of section 39E with its application to sale and leaseback and certain leveraged lease situations it is considered appropriate

to lay down what the Department considers are basic requirements for all leases. In this regard in recent years it has become clear that some so-called leases are in fact purchase agreements. The position has now been reached where it will be necessary for Assessors to carefully consider whether payments made by a "lessee" are lease rentals or whether they are, in substance, consideration for the sale of the goods purported to be leased. In the latter case, of course, the payments would be outgoings of a capital nature which are not deductible for profits tax purposes although they may qualify for initial and annual allowances.

64. In line with tax administrations in other parts of the world, factors to be examined by this Department to determine the question will include:

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

(b) the degree of relativity between the "residual value", by which the amount of monthly lease rentals is usually determined, and the reasonable commercial value of the goods at the expiry date of the lease.

65. So far as factor (a) is concerned, an agreement will generally be regarded as a purchase agreement if the lessee has a right or option to purchase the goods. If in the opinion of the Commissioner, such right or option would reasonably be expected not to be exercised, then such an agreement, notwithstanding its form, is a lease as defined. An agreement will be accepted as a lease, as distinct from a purchase agreement, if the lessee does not, either during the term of the lease or at its end, have an obligation, right or option to purchase the goods. It will correspondingly be unacceptable if the lessor has a right or option to require the lessee to purchase. An agreement is unlikely to be accepted as a lease if an associate of the lessee is given an obligation, right or option to purchase or the lessor has a right or option to require an associate of the lessee to purchase on the basis that such an arrangement is made to circumvent the law. Any right in the lessee to nominate a third party purchaser will be examined to ensure that it does not amount to an arrangement for purchase. An agreement for the lessee to have obligations, rights or

options to lease the goods for extended further periods, and the terms of any such extension will also be examined to determine whether the entire arrangement really amounts to a purchase.

66. As to residual values, it is the usual commercial practice for the amount of rent to be calculated, in so far as it is designed to cover the cost of the goods, on the basis of the difference between the cost of the goods and their assessed residual value at the end of the lease. Accordingly, the larger the residual value, the smaller would be the lease rentals. The residual value should represent a fair estimate of the market value of the goods at expiration of the lease.

Leveraged leases

67. In situations where the tax deferral benefits to a leveraged lessor represent a substantial part of the lessor's effective return on its own (non-leveraged) investment there may be a question whether section 61A would apply, i.e. whether it would be concluded that a lessor's participation had attaching to it a sole or dominant purpose of obtaining a tax benefit. It is therefore considered appropriate to set out the Department's views on the minimum standards with which leveraged lease transactions must comply if they are to be acceptable under the Ordinance. In this regard it is expected that future leveraged lease transactions should observe the following requirements.

Period of the lease

68. Generally, the lease period should not exceed 10 years. In appropriate cases the Department will consider longer periods where it can be established that the leased machinery or plant has an economic life greater than 10 years.

Rental rebate

69. Lease transactions which provide for a rental rebate to be paid to the lessee upon expiry or termination of the lease will not be acceptable.

Number of partners

70. Transactions involving more than 3 partners or where any partner's share in the profits/losses of the partnership is less than 30% will not be acceptable.

Partnership accounting period

71. Where partners in a leveraged lease partnership have common accounting periods, the return of income of the partnership should be furnished for the same accounting period. Where the partners do not share common accounting periods the Department will, as a general proposition, accept a partnership accounting period which corresponds to that of the majority partner(s).

Losses

72. The transaction should result in assessable profits to the partnership, before the set-off of losses, after the first three years' operation of the lease. The Department requires a profit of at least 1% of the cost of machinery or plant in the fourth year of assessment.

Rental structure

73. The total rental payable under the lease should be payable in equal amounts over the term of the lease – pro-rata in the first year where that year is less than a full year of income. Where rentals are payable in arrears it is expected that the partnership will return as assessable profits for a year the amount of rent that has been earned during the year; ie the assessable profits for a year will include rentals accrued at the end of the year.

Ships and aircraft

74. The lessee/ultimate end user must be a Hong Kong operator (see paragraph 20). Transactions involving ships will not generally be given a clearance.

Advances by lessee

75. The lease should not involve any arrangement for the lodging by the lessee with the lessor of security deposits or for the lessee to make any kind of advance to the lessor. In relation to partners' capital contributions, this requirement would extend to any indirect arrangements having much the same practical effect as an advance by the lessee to the lessor. No objection will be taken, however, where the lessee enters into back-to-back loan arrangements with the lessor on identical terms and conditions that apply to an existing loan between the lessee and a third party lender where that loan had been raised originally by the lessee to purchase the machinery or plant.

Premature termination of lease

76. If the lessee has a right to terminate the lease on payment of an amount to the lessor – for example, once the tax-loss phase of the partnership's life has passed – the amount so paid will be treated as assessable profits of the partnership. Similarly, amounts received by partners for an assignment of partnership interests will be regarded as assessable profits of the recipient.

Interest

77. Interest on moneys borrowed to produce assessable profits is incurred, and thus is allowable as a deduction, when it becomes due and payable. However, transactions under which more than what would normally be a year's interest is sought to be deducted in one year – or more than an appropriate portion where the first income year is not a complete year – will not be acceptable. Transactions which will not be acceptable will include those where the whole of the interest applicable to a loan is payable by instalments before any repayments of principal are to be made, and those where interest is capitalised back into a loan in any year because, inter alia, rental is insufficient to meet commitments under the loan.

Non-recourse debt

78. Financing on a recourse basis should be for at least 51% of the cost of the machinery or plant throughout the term of the lease.

Equity

79. In cases which do not involve a limited partnership it is expected that lessors themselves contribute capital for at least 35% of the cost of the machinery or plant. Interest free and interest bearing loans, even with recourse, will not be accepted. The minimum capital contribution should be maintained throughout the term of the lease. The partners must be fully at risk in relation to their capital contributions to the partnership. Arrangements, direct or indirect but having the same practical effect, which would result in reducing the capital at risk by the partners below 35% of the cost of the machinery or plant are not acceptable. The Department will not accept lease transactions where the partners use borrowed funds to specifically finance their capital contributions to the lease partnership. Such capital contributions will be required to be financed from the general pool of funds out of which the partner funds assets in the normal course of business.

Profit motive

80. The lessors (which generally should be financial institutions) must demonstrate a profit motive, aside from gaining tax benefits, for the transaction. This will generally be regarded by the Department as being satisfied where the aggregate taxable income of the lessors (or investors) over the term of the lease, after the set-off of losses, is not less than 1% of the cost of the machinery or plant.

General

81. Leveraged lease transactions that do not comply with these requirements may lead the Department to conclude that the arrangement has a sole or dominant purpose of obtaining a tax benefit. On the other hand it should not be assumed that because a transaction does comply it will thereby not be considered in the context of section 61A. There are other aspects of lease arrangements which do not lend themselves to specific guidelines but which, if encountered in practice, may lead to a conclusion that the arrangement has a dominant purpose of obtaining a tax benefit.

82. Finally, the requirements set out above will be reviewed from time to time and amended as necessary in the light of actual experience.