Financial Leases—How Can They Be Treated for Tax Purposes?

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Introduction

A lease is an agreement under which the lessor grants to the lessee the right to use an asset for a defined period of time in exchange for a stated rental payment. From an economic point of view, lease agreements can be broadly divided into two types (recognizing that some agreements may fall into a gray area between the two): financial lease (or finance lease) and operating lease. A financial lease is one under which the risks and benefits inherent in the ownership of the asset over its lifetime are transferred to the lessee, while the legal title to the asset remains with the lessor. The agreement may provide for purchase of the property by the lessee upon expiration of the lease term. An operating lease is any lease other than a finance lease, i.e. one where the risks and benefits incident to ownership remain largely with the lessor. A quintessential example of an operating lease is one for a very short term, e.g., one week.

Even though under a finance lease the lessee does not immediately (and may never) obtain legal ownership of the leased asset, in substance the lessee does acquire the economic benefits related to use of the asset for most or all of its economic life in exchange for payments generally equaling the fair market value of the asset plus financing charges. In economic terms, a finance lease is substantially equivalent to a loan which is secured by the asset in question.[1]

The accounting treatment of a lease often differs depending whether the agreement qualifies as a financial or an operating lease.[2] For accounting purposes, assets subject to a finance lease are in many countries treated as owned by the lessee, and the lessee depreciates the assets under a depreciation policy consistent with that of owned depreciable assets. However, this treatment is not universal, and in

some countries financial leases are not accounted for differently from operating leases.

Under many tax systems, finance leases are treated differently from operating leases. Thus, in the case of finance leases the tax treatment resembles the tax treatment of a sale on credit: the lessee is treated as the owner of the asset and the lessor as a financier. The lessee takes depreciation on the asset while the portion of the lease payments representing interest is deductible by the lessee. The lessor on the other hand is treated as receiving interest in the same amount deductible by the lessee, while the balance of the lease payments represents the repayment of the principal of a loan. The difficulty lies in determining what portion of each lease payment represents interest. One way to do this - in the case of a lease which is designed to pay for the property completely - is to assume that the present discounted value of the lease payments is equal to the fair market value of the property. If the fair market value or the discount rate is known, then the interest can be calculated. Another possibility is to rely on the values used by the parties, with a possibility of adjusting this to fair market value in cases of abuse.

Country Practices

Some countries deal with all leases according to their legal form, and do not draw a distinction between finance and operating leases. In these countries, all leases are in effect treated as operating leases.

Countries that look at the substance of a lease agreement in order to distinguish between finance and operating leases generally rely either on specific rules in their tax laws regarding lease agreements[3] or on general substance-over-form rules.[4]

Specific rules either adopt a mechanical test[5] or require each situation to be evaluated to determine its substance. The latter approach is also followed for accounting purposes under IAS 17.

The consequences of treatment of a finance lease as a form of financing is that the portion of the payments in excess of the market value of the asset is treated as

interest.[6] The lessor is generally subject to tax on the portion of the payments treated as interest and the remainder is regarded as repayment of capital.[7] Conversely, for an operating lease the entire lease payment is generally deductible by the lessee as a business expense and is taxable to the lessor.

Where tax law draws a distinction between financial and operating leases, the right to account for depreciation of an asset underlying a financial lease is generally assigned to the lessee.

Fashioning a Solution

The simplest approach may be to treat all leases according to their legal form.[8] Where a country does not provide tax benefits in the form of accelerated depreciation or investment credits, following legal form may not lead to significant tax policy problems, since the tax consequences in terms of the income and expenses of the two parties to the lease agreement will be roughly the same regardless of whether legal form is followed. However, where depreciation is accelerated, there can be a substantial difference between the two approaches.[9]

If a decision is made to treat finance leases as financing devices, it is necessary to determine when a lease will be considered a finance lease. The greatest certainty for taxpayers and tax administors is achieved by including explicit rules in the tax law or regulations. There are several tests that may be used for deciding when a lease is a finance lease in substance. Examples of indicators that the lease is a finance lease are the following:

- the title to the asset is transferred to the lessee at the end of the lease term;
- the lessee has an option to purchase the asset at the end of the lease term at a price that is fixed, particularly where the price is significantly lower than the market value of the asset at that time;
- the lease term extends over most of the economic life of the leased asset;
- at the start date of the lease the present value of the rental payments represents a high percentage of the fair market value of the asset (e.g., 90 percent);

- the asset is so specialized that for all practical purposes only the lessee can use it;
- the lessee has the right to extend the lease term for a rent that is lower than the market rate.

The above factors may either be taken into account in evaluating the economic substance of each particular situation, or be incorporated into a mechanical test. The advantage of a mechanical test is certainty. If a mechanical test is adopted, it should be carefully drafted so as to minimize problems of abuse. The alternative of a looser standard allows each situation to be evaluated more particularly. This approach, while less certain, may have the advantage of greater conformity with financial accounting, since financial accountants would typically not take a mechanical approach.[10]

An alternative approach which might be suitable for countries that closely base their tax accounting on financial accounting would be to provide no special rules for finance leases in the tax laws. This would have the effect of incorporating the financial accounting rules. Depending on these rules, the result may be a substance-over-form approach (as in countries which deal with this issue consistently with IAS) or an acceptance of the form of the transaction.

In an international context, financial leases may be used as a tax planning tool due to the fact that some countries take a formal approach in classifying leases, while others look at the substance of lease agreements. Thus the lessor might be treated as the owner of the property in one country and the lessee treated as the owner in another country or countries. As a result, depreciation may be claimed on the asset in both countries (e.g. the lessor's country views it as an operating lease allowing the lessor to take the depreciation on the asset while the lessee's country considers it a finance lease and lets the lessee claim the depreciation). Situations like this may be avoided by including special anti-avoidance rules in the tax law, for example allowing depreciation of an asset that is leased under a finance lease only if no other person takes depreciation for the same asset. [11]

For Further Reference

Lee Burns and Richard Krever: *Taxation of Income from Business and Investment, in* 2 Tax Law Design and Drafting 659-662 (1998)

International Accounting Standard (International Financial Reporting Standard) 17

Lindencrona & Tolstoy, *General Report*, 75a Cahiers de droit fiscal international, 30, (International Fiscal Association ed., 1990)

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[1]Where the asset was owned by the lessee immediately prior to the lease (i.e. in the case of a sale-leaseback), a finance lease therefore is equivalent to a loan from the lessor to the lessee. Where the lessor purchases the asset from a third party and then leases it to the lessee, the transaction is equivalent to a sale by the third party to the lessee, which is financed by the lessor.

[2] International Accounting Standard 17 (revised 1997) (IAS are now known as International Financial Reporting Standards).

[3]E.g., art. 12, Law on Profit Tax, Law No. 414, Official Monitor, June 27, 2002 (Romania).

[4]For example, Germany has a general provision in its fiscal code assigning property to its owner. (AO 39). This has been interpreted by case law as calling for evaluation of financial leases according to their economic substance. See Wolfgang Fliess, National Report, in 75a IFA Cahiers 143, 144 (1990).

[5]E.g., Income Tax Assessment Act 1936, Division 16D (Australia).

[6]In Mexico the amount above the original amount of investment is treated as interest. The original amount of investment is the value of the asset shown in the respective contract. Ley de Impuesto Sobre La Renta §9, §44.

[7]In Australia the repayment of principal is non-assessable income while the payment of interest is assessable income. Australian Tax Handbook 636 (2000).

[8]This may not be the case where a country's income tax rules are closely based on commercial accounting. In such countries, the simplest approach may be to provide no special rules for tax purposes, with the result that those leases treated as finance leases for financial accounting purposes will also be so treated for tax purposes, and no special adjustments between the financial accounting treatment and the tax treatment will be necessary.

[9]Where depreciation is accelerated, if the lessor is treated as the owner for tax purposes, the benefits of the accelerated depreciation will go to the lessor. This will reduce the taxable income of the lessor, and correspondingly increase that of the lessee. If the lessee is indifferent to this, for example because it has large unused net operating losses, then the parties will prefer for the lessor to receive the tax benefits.

[10]See IAS 17 (revised 1997) ("Whether a lease is a finance lease or an operating lease depends on the substance of the transaction...Examples of situations which would normally lead to a lease being classified as a finance lease are.... Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are....").

[11]Such a rule exists, for example, in Denmark. *See* Christian Emmeluth, Denmark, 22 Tax Management International Forum 13 (June 2000). Few other countries have such a rule, however. *See id.*
In the US, the Tax Court indicated its displeasure with "double-dip" leasing transactions. "There is nothing...which compels us to ignore the form of a transaction structured to obtain tax benefits in one jurisdiction and to restructure the transaction, at the insistence of the taxpayer, in order to confer tax benefits in another jurisdiction-in short, to enable the taxpayer to play both ends against the middle."*Coleman v. Commissioner*, 87 T.C. 178 (1986). See O'Connor & Wiesner, *National Report, United States*, 75a Cahiers de droit fiscal international 352 (1990).