TAX ISSUES IN FINANCING TRANSACTIONS

COMMENTARY

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INTRODUCTION

This paper is a commentary on John Field's paper dealing with "Tax Issues in Financing Transactions".

John has raised in his paper the comments made by Michael Carmody, the Commissioner of Taxation, in a speech to the Tax Institute on 19 March, 1997, concerning a Tax Office review of cross border leasing. That speech by Mr Carmody was interesting for the light it shed on the vigour with which the Tax Office is re-examining the tax treatment of many areas of financing practice which would until now have been regarded as established.

These reviews appear to be taking place as a result of the decision in *Spotless Services* which concerned the general anti-avoidance provision, Part IVA.

Whilst it is obviously the responsibility of the Tax Office to remain vigilant in reviewing the application of Part IVA, some of the areas which are being looked at are quite surprising. Whilst I am optimistic that this upheaval of accepted practice will die down in due course and a more considered approach will return, the practical issue which is raised in the meantime, is whether delays experienced in dealing with the Tax Office whilst these reviews go on may threaten the viability of some commercial transactions.

I propose to comment in particular in this paper on two of the areas of review raised by Mr Carmody in his speech which may be of interest to the Banking Law Association:

- Cross-border leasing; and
- Infrastructure bond financing.

CROSS BORDER LEASING

Background

A cross border lease is, quite simply, a lease between a lessor located in one country and a lessee located in another. The benefit of a cross border lease to an Australian lessee, as distinct from a wholly domestic lease, is that the lessor will assess his tax position in accordance with his own tax rules. Because of this a foreign lessor can in certain circumstances gain depreciation allowances from its own government where the Australian Government has decided to deny such allowances to Australian lessors. Effectively the foreign government is granting allowances to the leasing company in their country which will flow, in part, for the benefit of the Australian lessee – a situation that has obvious appeal.

For example, in many cases a foreign lessor may lease assets to Australian State Government entities. An Australian lessor cannot effectively do so because of section 51AD and Division 16D of the Income Tax Assessment Act (the Act). Similarly, a foreign lessor can, in certain circumstances, provide a hire purchase to an Australian hirer whilst retaining the benefit of depreciation deductions. An Australian lessor could not do so.

In his speech to the Tax Institute Mr Carmody described cross-border leasing as a raid on the foreign country's tax system and seemed to suggest that Australia should be actively discouraging such transactions. Mr Carmody expressed concern that if we do not support the tax systems of other countries then we are inviting foreigners and Australians alike to be disrespectful of our own system.

Mr Carmody also suggested that many US leases do not comply with the requirements of the US Tax Code.

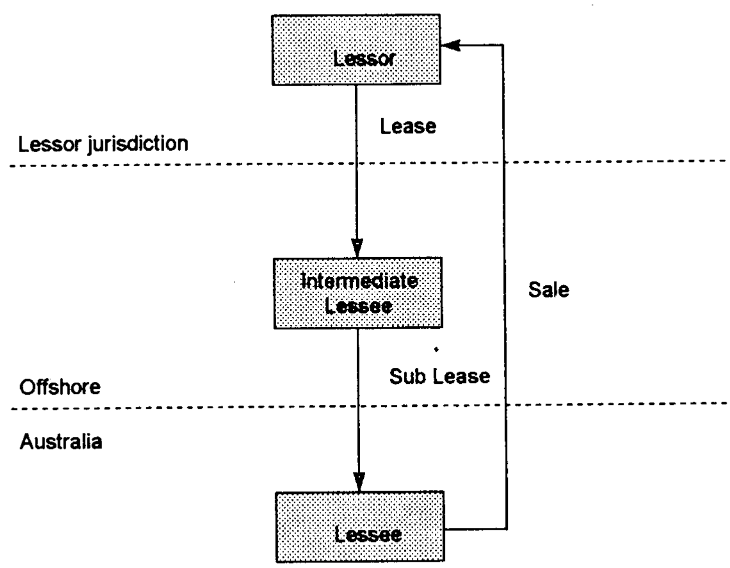
Against this is the fact that in many situations the overseas tax authorities provide rulings on cross border leases, and in virtually all cases there is clear evidence that the relevant revenue authorities are aware of the transactions.

It is also true that the Australian Government has been aware of cross border leasing for a long time. As far back as 1982 section 51AD was introduced to specifically prevent cross border leasing by Australian lessors to non-residents (ie where there is a cost to the Australian revenue). This legislation has been paralleled in many countries around the world (ie preventing "outbound" leasing). However, Australia has no specific legislation preventing "inbound" cross border leasing for the benefit of Australian lessees. Nor am I aware of any other country which has legislated to deny the passing of foreign lease benefits to lessees in that country.

Whatever the position, I am sure Mr Carmody would agree that the ATO does not set tax policy. Nor does it interpret US tax law. The ATO will therefore assess cross border leasing transactions based on the current tax law in Australia.

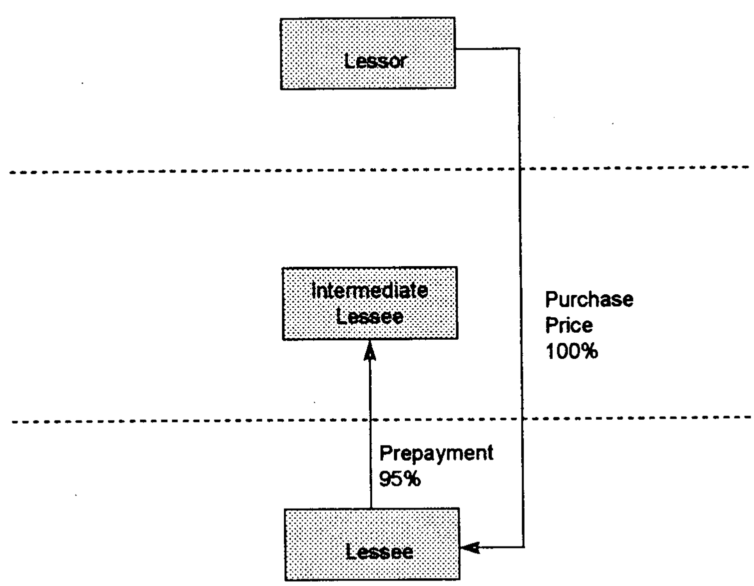
Analysis of a Cross Border Lease

The application of the Australian tax law can be examined in the context of a reasonably standard cross border lease structure:



This structure involves a lease from a foreign lessor (eg US), through an intermediate lessee, to Australia. Typically, the Australian lessee will be a State Government entity or a major corporate because the relatively high fixed costs involved in setting up a cross border lease mean that it will only be attractive for lessees with high value equipment.

The lessor will pass some of the benefit from the depreciation allowances which it can claim for its own tax purposes to the Australian lessee in the form of a lower implicit lease interest rate. The lessee will generally lock in this benefit in advance by prepaying its lease rentals. The cash flows for the lessee are therefore as follows:



The differential between the amount the lessee receives for the sale of the equipment and the amount needed to prepay the lease is known as the "Day 1" or "Net Present Value" benefit. This is a real cash benefit derived by the Australian lessee and is the motivation for entering into the lease. Benefits typically range between 5% and 10% of equipment value.

The net present value benefits to Australian lessees from entering into a cross border lease are typically included in the lessees' assessable income for Australian tax purposes. In circumstances where the relevant entity is a State instrumentality (or other tax exempt entity) the NPV benefit represents an amount received by the relevant State which reduces its overall need for Commonwealth grants.

The ATO review of the Australian tax treatment of cross border leases is focused in particular on whether withholding tax should be applied to payments made by Australian lessees to foreign lessors. As a practical matter, it is very unlikely that any change of Tax Office practice would lead to the collection of any additional revenue. Rather, as John Field has identified, the imposition of a withholding tax would render the transactions uneconomic and they simply would not proceed (into Australia). The benefits which cross border leases deliver – hundreds of millions of dollars per annum – would be lost by Australia, and the tax on those benefits would be lost by the Tax Office.

Technical Position

At the outset, it can be noted that the position at law is sufficiently in favour of cross border leasing that the Tax Office has provided positive rulings on cross border leases for the past 15 years and more. During that time there have obviously been some changes in statute and common law but none, it is submitted, that would warrant a change in practice on the part of the Tax Office.

The questions now being considered by the Tax Office are as follows:

1. **Is there a royalty?**

   As can be seen from the diagram above, there is only one payment made from Australia to which withholding tax could apply in the typical cross border lease – the prepayment of rentals. Is this amount a royalty subject to withholding tax?

   Section 128AC of the Income Tax Assessment Act (the Act) was inserted by Taxation Laws Amendment Act (No 2) 1986. Section 128AC deems payments made under a hire purchase to consist of interest and principal.

   The current royalty withholding tax provisions in section 128B(2B) (where the taxation of royalties was changed from tax by assessment under section 26(f) to a withholding on gross royalties paid) was inserted by Taxation Laws Amendment Act (No 5) 1992.

   The question which arises is whether a payment under a hire purchase arrangement falling within section 128AC can also be subject to tax under section 128B.

   Quite apart from the principles of statutory interpretation which indicate that the specific provisions of section 128AC should override the general rules on royalties in section 128B, there is an inconsistency in attempting to argue that a payment which falls within section 128AC could also be a royalty to be dealt with under section 128B.

   It is clear, that as a matter of general common law, there is a distinction between a payment for the *acquisition* of an asset and a payment for the *use* of an asset. Only the latter satisfies the definition of a royalty at common law.[1]

   This concept is also clearly accepted by the Commissioner in Income Tax Ruling IT 2660 (eg paragraphs 13 and 16) in relation to the extended definition of royalty in section 6(1) of the Act.

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1 Refer *Stanton v FC of T* (1955) 92 CLR 630.

A hire purchase represents (especially for tax purpose) an arrangement to acquire an asset rather than an arrangement for the use of an asset. This is the effect of the deeming arrangements in section 128AC. It is submitted that it would be undermining section 128AC if a payment which was confirmed by that section to be a purchase price component (albeit possibly paid over time) was taxed simultaneously under section 128B as a payment for the "use" of an asset.

2. **Can Part IVA apply?**

The operation of Part IVA will be extended to cover withholding tax upon the introduction of Taxation Laws Amendment Act (No 2) 1997. Assuming this Act is successfully introduced, the question will arise whether a cross border lease may involve the avoidance of withholding tax.

As with most Part IVA questions, this can only be answered fully with reference to the facts and circumstances arising in each particular case. However, a couple of observations can be made on a general level.

Firstly, as explained above, if withholding tax applied to the payments under a cross border lease the lease would quite simply not proceed. In this case, it would be more attractive for a foreign lessor to lease assets to a lessee in another country in preference to entering into a lease into Australia. Accepting this it is hard to see that any avoidance of withholding tax has occurred. That is, there was no alternative arrangement under contemplation where withholding tax would have been paid.

It is also hard to see how there has been any avoidance of withholding tax when, even in the broadest economic sense, there is no finance provided to the Australian lessee. The prepayment of rentals by the Australian lessee is not made to avoid any "interest" amount to which withholding tax may apply but rather is made because the lessee would prefer to arrange any financing from its normal sources and enters into the cross border lease purely to derive the net present value benefit.

3. **Does the Lessor have a permanent establishment?**

The definition of permanent establishment in section 6(1) of the Act includes "a place where a person has, is using or is installing substantial equipment or substantial machinery". Similar definitions are also found in many of Australia's tax treaties. If it is found that a lessor is receiving income at or through a permanent establishment, then generally speaking this income may be subject to income tax in Australia.

However, if it is considered for the purposes of section 128AC that the lessor has effectively sold equipment to an Australian lessee under a hire purchase agreement it would be inconsistent to argue that that lessor is at the same time using that equipment in Australia for the purposes of the definition of permanent establishment. This interpretation has been accepted by the Tax Office over a long period of time and has been reflected in a number of private rulings. There has been no change in the relevant law in this area.

INFRASTRUCTURE BONDS

Background

Mr Carmody also made reference to the possible application of Part IVA to infrastructure bonds in his speech of 19 March, 1997.

Infrastructure bonds were introduced following Paul Keating's One Nation statement in 1992. They could be used by companies constructing qualifying infrastructure projects. The interest on the bonds is tax exempt (or rebatable) in the hands of the infrastructure bond investor, whilst the issuer is denied a deduction for the interest which it pays.

Infrastructure bonds were designed quite simply as a "tax loss transfer" mechanism. The principle behind the bonds is that whilst infrastructure projects will almost always be in tax loss for a long period of time after start-up they are typically unable to take advantage of the tax loss grouping provisions in the Act. This is generally because these projects are so large that they are owned by a consortium rather than a 100% parent (as required by section 80G).

The bonds therefore enabled a project to get some immediate benefit for its tax losses, in the form of a lower net interest charge. This lower charge arises because an investor is willing to forego some of its return to reflect the fact that the interest is tax free.

The infrastructure bond benefit is delivered to projects in the critical early phase of their operation. This benefit typically enables projects to get over a debt service "hump" in a small number of key years and therefore enables issuers to gear-up the infrastructure bond benefit across the life of a project. Because of this the total benefit to government and the community, in terms of the amount of expenditure which can be financed by the private sector or the cost of infrastructure to the community, is a multiple of the cost of the bonds in terms of tax revenue foregone.

Following Mr Costello's announcement on 14 February this year, there will be no new infrastructure borrowing certificates issued by the Government. However, the tax treatment of infrastructure bonds will remain relevant for projects which have already been certified. Many of the infrastructure bonds which have been issued by these projects will remain on foot for a number of years to come.

In his speech to the Tax Institute, Mr Carmody conceded that it would be incongruous for Part IVA to apply generally to deny the benefits which the tax law expressly provides for in relation to infrastructure bonds. He said, however, that regard must be had to the whole financing structure including the direct infrastructure bond financing, the rate of interest, any risk to the investor including whether they are locked in by options, the return on an after tax basis and how the funding took place.

These are not the kind of words which fill investors with comfort and certainty in making their business decisions. However, following Mr Carmody's comments a written assurance has been obtained from Mr Michael D'Ascenzo, the ATO's Chief Tax Counsel, that there has been no change in policy regarding infrastructure bonds. Therefore, it should be clear that any transaction which has already been approved by the Tax Office is not subject to review. Presumably, other transactions which are on all fours with such transactions should also come within the scope of Mr D'Ascenzo's assurance.

Infrastructure Bonds and Part IVA

It is easy to see how a superficial view could be formed that Part IVA may apply to infrastructure bonds, as they clearly carry certain tax advantages. However, there would be something slightly crazy about Part IVA applying to a specific tax concession, and this was recognised when Part IVA was originally introduced. In the Second Reading Speech introducing Part IVA, the Treasurer stated:

> "But I do assert that taxpayers who simply take advantage of concessions for the purposes for which they were put in law cannot and will not be affected by the new provisions.
>
> Specifically for example, Part IVA will not deny to people who simply respond to our tax concessions for investment in Australian films the benefit of the tax advantages that are part of those concessions.
>
> But I think it incontrovertible that blatant misuse of those and other 'incentive' concessions ought to be within the scope of Part IVA."

So, unless there is a blatant misuse of the infrastructure bond concession, it would seem that Part IVA should not apply. In this regard, it would be wrong to say that the conventional sale of infrastructure bonds to investors was a blatant misuse of the concession. Whether this fact is understood by the ATO, and by government, is unclear however, because there has been a great deal of confusion surrounding infrastructure bonds generally.

Double Dipping

Anyone who was there when the Treasurer announced in February that the infrastructure bond concession was being terminated and who has read subsequent press articles would know that "double dipping" is bad. What is double dipping though?

Certain complex infrastructure bond arrangements – commonly involving non-residents or tax exempt bodies – were originally described as double dipping. The "double dip" in these arrangements arose because investors received tax exempt income without any net symmetry on the part of the issuer. Arrangements of this type were largely stopped by announcement in October, 1995 and thereafter by stricter review on the part of Invest Australia – the body administering infrastructure bonds.

However, more recently a view has formed that the ability of investors to borrow against infrastructure bonds constitutes double dipping and squeezes more than was intended out of infrastructure bonds (at the cost of the Revenue). The double dip (so the theory goes) occurs when the investor receives both tax exempt income on the one hand and an income tax deduction on the other. This is wrong:

(i) Infrastructure bonds would be *disadvantaged* relative to other investments if they could not be geared. Effectively this would reverse (at least in part) the very point of the concession.

(ii) The ability to deduct interest expense whilst deriving exempt income was specifically provided for in the infrastructure bond legislation. It is not an abuse of the concession.

(iii) **There is no difference in the cost to the revenue** between an investor taking $100 out of the bank (where he would have earned taxable interest) to buy a bond and an investor borrowing $100 and paying deductible interest to buy a bond.

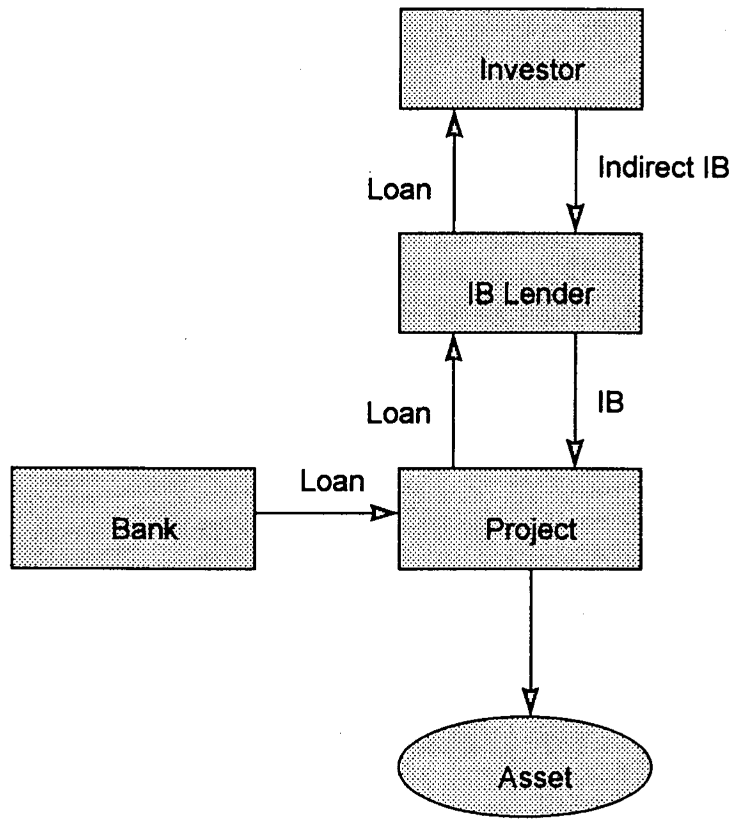
If interest rates are 10%, the revenue loss is tax on $10 in each case – either the taxable interest not earned or the interest deduction claimed.

If gearing was not allowed the only effect would be to limit infrastructure bond investments to the wealthy who can come up with the cash. Moreover, in all likelihood the same number of bonds would be sold but, because the supply of investors has reduced, the proportion of the benefit which will flow through to the project issuer will reduce.

"Contrived" Arrangements

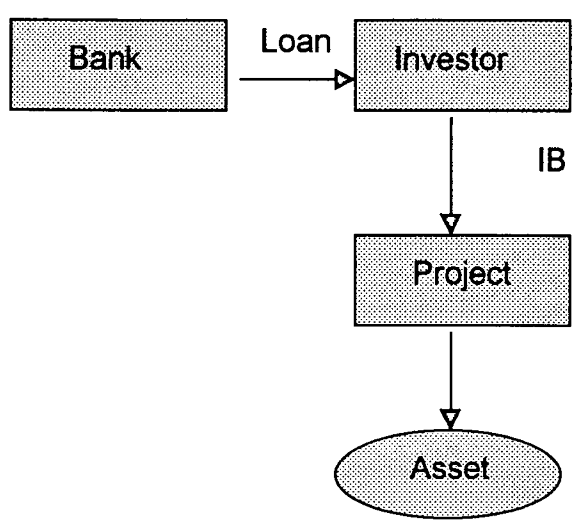
The other aspect of infrastructure bond financings which may initially cause some suspicion is their complexity. The Tax Office (often correctly) tend to think something underhand is going on when they see complex arrangements which cannot immediately be understood.

A typical infrastructure bond financing would proceed along the lines of the following:



However, whilst complex, it should be understood that this arrangement is designed to minimise administration, simplify security issues and avoid bank margins. It is not driven by a desire to increase tax benefits and should not cause consternation at the Tax Office.

This point can be understood when the structure above is compared to what might initially be considered a more "normal" arrangement:



This structure is much simpler, but the tax position of each participant is essentially no different:

(i) the bank is receiving interest income on a loan;

(ii) the investor is receiving infrastructure bond interest and paying interest on its borrowing;

(iii) the IB lender is net tax neutral; and

(iv) the project pays net non-deductible infrastructure bond interest.

What Next?

This paper was written prior to the Federal Budget on 13 May, 1997. It is anticipated that a "replacement" scheme to counteract the tax disadvantage suffered by private infrastructure projects will be introduced in the Budget.