

New Tax Threat for Leasing - Depreciation Recapture Laws to Change

Proposed amendments to depreciation recapture provisions of the Tax Act may result in higher tax balancing charges, including on termination of some lease arrangements.

New tax legislation being considered by federal parliament proposes significant changes to laws covering the recapture of tax depreciation deductions. If the Taxation Laws Amendment Bill (No4) 1991 is passed in its present form, the changes could have a considerable impact on lease transactions (including transactions already in existence) where the lessor sells the leased equipment after 19 December 1991.

The amendments to section 59(4) of the Income Tax Assessment Act will affect any sale of depreciable property occurring after 19 December 1991. In broad terms, the provisions will only operate where both the sale price of depreciable equipment is less than market value, and the vendor and purchaser are not dealing at arm's length in relation to the sale. Where both of these conditions are satisfied, the provisions will deem the vendor to have received the market value of the equipment (rather than the lower price actually paid) for the purposes of depreciation provisions of the Act.

Accordingly the assessable balancing charge in those circumstances will be determined with reference to the amount by which the market value of the equipment exceeds its then depreciated value.

Impact on Leases

For many leases, including consumer leases and big ticket leveraged and equity leases, it is common practice for a lessor to sell the leased asset to the lessee on lease termination for a price equal to a nominated lease residual value. Often that nominated residual value bears no real relationship to the market value of the asset. In many cases, the market value will significantly exceed the residual value.

If the amending Bill is enacted in its present form, the practice of selling high value leased assets to the lessee at a lower residual value may carry a significantly higher tax cost for the lessor — it could be expected in these situations that the parties would not be regarded as dealing at arm's length.

In situations where the lessee has provided comprehensive indemnities to the lessor in relation to changes in specified tax assumptions, this additional tax cost will be passed on to the lessee.

Where the lessor is not indemnified, the lessor will

now have a significantly greater concern with the market value of leased assets. The lessor may seek to increase the price at which it will sell the asset to the lessee in circumstances where the market value is higher than residual value, in order to preserve its anticipated rate of return. Any attempt to do so may raise a question as to whether there is an enforceable implied promise to sell the asset for its nominated residual value.

If the Bill is enacted in its present form, it may also provide an incentive for lessor and lessee to agree to an extension of the lease term, rather than to a sale of the leased assets.

Effect of the New Provisions in Other Contexts

The proposed amendments will apply to any non-arm's length sale of depreciable equipment at less than market value. However, in the case of sales between group companies under common ownership, the effect of the proposed amendments will be ameliorated by other proposed changes (contained in the same Bill) which (in limited circumstances) will extend roll-over relief to depreciation balancing adjustments.

Other Proposed Balancing Adjustment Amendments

Similar changes to those outlined above will be introduced in relation to the recapture of certain deductions allowed under Division 10A (timber industry) and section 73CA (scientific research expenditure) of the Income Tax Assessment Act. Other provisions will operate to deem market value transfers in relation to certain partial changes in the ownership of depreciable property (eg occurring on the reconstitution of a partnership) and in relation to partial ownership changes of other property which has attracted a capital allowance under either Division 10 (mining), Division 10AAA (mineral transport) or Division 10AA (petroleum operations). □

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