IT 2287 - Income tax : deductions for lease shortfall payments

TAXATION RULING NO. IT 2287

INCOME TAX : DEDUCTIONS FOR LEASE SHORTFALL PAYMENTS

F.O.I. EMBARGO: May be released

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F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1077993	CHATTEL LEASES	25(1)
	SHORTFALL PAYMENTS	51(1)

OTHER RULINGS ON TOPIC IT 28

PREAMBLE The decision of the Federal Court in FCT v. E.A. Marr and Sons (Sales) Ltd, 84 ATC 4580 : 15 ATR 879, (the Marr case) calls for a review of official practice in relation to deductions claimed for shortfall payments made by lessees under chattel lease agreements. The shortfall payments in that case were made on premature termination of the leases and represented the entitlement of the lessor to arrears of rentals under the leases, future rentals (with rebates in some cases) and the residual value of the plant sold. More often, shortfalls arise where leased goods are sold at the end of the lease term and the sale proceeds less sale costs are insufficient to meet the agreed residual. In these circumstances, the lessee may be required to make up the shortfall to the lessor.

FACTS 2. Present official practice originates from the statement issued by the then Commissioner on 6 July 1960 on "Leasing Arrangements of Plant and Machinery". The statement is repeated in Taxation Ruling No. IT 28 and, for present purposes, the following extract is relevant:-

> "Another relevant factor that would be regarded as inconsistent with a finding that the transaction was a normal commercial lease would be the inclusion in the leasing agreement of a provision under which, in the event of the sale price of the goods falling short of an agreed residual value, the shortage should be paid by way of adjustment by the lessee to the lessor."

3. Chattel leases were not necessarily rejected for income tax purposes solely on the basis that deficiency clauses were incorporated in the lease agreements. In memorandum from this office of 10 November 1961, H.O. reference J146/569 P4, it is stated:-

> " It is mentioned in amplification of the former Commissioner's circular letter, dated 6th July, 1960, that a provision for payment in the nature of an adjustment of lease rentals, either to or by the

lessee, in relation to the sale price of the leased goods at the expiration or earlier termination of the leasing period, would be regarded as transferring the risk of loss or the right to profit on disposal, which is inherent in the ownership of the leased goods, from the lessor to the lessee. Accordingly, the transaction would be regarded as inconsistent with the provisions of a normal commercial lease.

On the other hand, objection would not be taken to a provision whereby the lessor would be indemnified against such losses as are occasioned by the neglect or misuse of the leased goods by the lessee.

Further, a provision whereby the lessor would be indemnified against an actual loss incurred after termination of an original or a renewal lease, on the sale of the goods to a person at arm's length from the lessee, would not be regarded as being wholly inconsistent with the terms of a normal commercial lease. This view is, however, necessarily subject to the following qualifications:

(i) The amount of loss to be indemnified should be demonstrated by a bona fide sale of the leased goods or, if a sale cannot be effected, by an independent valuation, and quantified by the deficiency in the sale price or valuation in relation to the residual value of the leased goods.

(ii) Where, in consequence of the sale, the goods come into the possession of the lessee or a nominee or agent of the lessee, the lessee should be relieved of all obligation to make payment under the indemnity provision.

(iii) The lessee should acknowledge that the indemnity is of such a nature as to constitute a capital payment on his part (as distinct from an adjustment of rentals) and, accordingly, not deductible in his income tax assessments.

(iv) The lessor should undertake to account for the indemnity, for income tax purposes, as part of the consideration receivable on the sale of the goods or, alternatively, to include it in his returns as an ordinary business receipt."

4. Relevant to this Ruling is qualification number (iii). The decision in the Marr case calls into question the assumed effect of acknowledgements in lease documents that final payments to lessors in respect of deficiencies or shortfalls are capital payments and, accordingly, are not deductible.

5. The Marr case was concerned solely with the deductibility of lease shortfall payments. The Commissioner

argued that the company's leasing activities did not form part of its business. Alternatively, if the activities formed part of its business, it was contended that:-

(a) the lease deficiency payments were not incurred in the course of gaining or producing assessable income but in the course of winding up the business; and

(b) the lease deficiency payments were capital in nature.

6. The Federal Court unanimously rejected the Commissioner's arguments and found that the company's business activities included leasing of plant to associated companies and wholly owned subsidiaries. It derived assessable income from these activities and hoped to ultimately derive dividend income from its subsidiaries. The lease shortfall payments were incurred in gaining or producing assessable income, were not incurred in the course of winding up the taxpayer's operations and were not capital in nature.

7. The question raised by the decision in the Marr case is whether a lessee not in a business of leasing plant, e.g., a taxpayer who, as lessee, leased chattels for use in his own business operations, would be entitled to an income tax deduction for lease shortfall payments.

8. There are no decided cases directly in point. On the other hand there are a number of decisions of Taxation Boards of Review where it has been decided that a surplus over and above the residual value of chattels acquired by a lessee and subsequently sold is a revenue item and assessable income under sub-section 25(1), c.f., Case C56, 71 ATC 247: Case 53, 17 CTBR(NS) 339; Case Fl, 74 ATC 1: Case 19, 19 CTBR(NS) 134; Case M40, 80 ATC 294: Case 16, 24 CTBR(NS) 146.

9. Observations in some of the decisions point to income tax deductions being allowable for lease shortfall payments. For example, in Case C56 Messrs Burke and Smith in their joint reasons said:

> "Here the several rent payments made by the taxpayer from month to month were intrinsically of a revenue nature. It is our view that if the vehicle sold by the taxpayer had realised less than the residual value of $860 the difference would have partaken of the character of the rent payments and would have been an outgoing on revenue account and so properly deductible for tax purposes."

10. In Case Fl Mr Dempsey referred to the decision of Mr O'Neill in Case C56 and said:

> "I agree with Mr O'Neill in his statement that he can see nothing wrong in principle in regarding any adjustment as between the financier and the lessee

relative to the stipulated residual value as being one made on revenue account."

11. In FCT v. Reynolds, 81 ATC 4131 : 11 ATR 629, the taxpayer, who carried on a business as a log haulier, had a truck on lease. Before the lease expired and with approval of the lessor he sold the truck as agent for the lessor. The sale price exceeded the pay out figure under the lease agreement and in accordance with normal practice the taxpayer was allowed to retain the surplus. The Supreme Court of Tasmania held "that the sum of money in question was income and assessable as such, pursuant to section 25(1)." Although the decision may not be authority in the context of income tax deductions for lease shortfall payments, nevertheless, it does point to the conclusion that payments in relation to the use of chattels for income producing purposes, whether they are payments to or by the lessee, are not of a capital nature.

RULING

12. Where a lease agreement, which is otherwise acceptable as a normal commercial leasing transaction, makes provision for a lessee to indemnify a lessor against an actual loss incurred after termination of an original or renewal lease on the sale of goods, it is no longer necessary for the lessee to acknowledge that the payment is of a capital nature and not allowable as an income tax deduction. Indemnities or shortfalls of this nature are allowable deductions under sub-section 51(1) where the leased goods have been used by the lessee in the production of assessable income. To the extent that the leased goods have not been so used the indemnities or shortfalls are not deductible. Deductions are allowable whether the lessee taxpayer carries on a business the activities of which include the leasing of plant as in the Marr case or whether the lessee merely uses the leased goods in the production of assessable income. Taxation Ruling No. IT 28 is modified accordingly.

13. Current cases and any undetermined objections or appeals with claims of this nature should be finalised in accordance with this ruling. If there is any doubt whether a particular lease agreement should be accepted as a normal commercial leasing transaction, the facts may be referred to this office for consideration.

14. Leases that attempt to manipulate the deduction, e.g., low uneconomical rentals over the period of the lease with an unduly high residual value should, of course, be rejected for income tax purposes.

COMMISSIONER OF TAXATION
11 April 1986

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