


TR 98/15 - Income tax: taxation consequences of trading in a previously leased asset for a replacement leased asset

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Taxation Ruling

Income tax: taxation consequences of trading-in a previously leased asset for a replacement leased asset

other Rulings on this topic

IT 28; IT 87; IT 278;
IT 2317; IT 2395;
TD 93/119; TD 93/142

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Preamble

*The number, subject heading, and the **Class of person/arrangement, Ruling and Date of effect** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

Class of person/arrangement

1. This Ruling deals with several issues that arise when a taxpayer trades in a previously leased asset used for income producing or business purposes, for a leased replacement asset.
2. In this Ruling, a reference to a legislative provision is to a provision in the *Income Tax Assessment Act 1997* (ITAA 1997) unless it is specifically denoted as a provision from the *Income Tax Assessment Act 1936* (ITAA 1936). Also, a reference to a provision in the ITAA 1997 should be read as a reference to any equivalent provision in the ITAA 1936.
3. Specific issues covered in this Ruling are:
 - (a) whether trade-in credits form part of assessable income under sections 6-5, 42-190, 42-240 or 42-390, Subdivision 20-B, or, where applicable, Parts 3-1 and 3-3; and
 - (b) whether certain initial payments (balloon payments, prepayments, deposits or down payments) are tax deductible under section 8-1.
4. The Ruling discusses the possible application of the capital gains tax provisions contained in Parts 3-1 and 3-3 to any capital profit derived on the disposal of a previously leased asset.

TR 98/15**Previous Rulings**

5. The content of Taxation Determination TD 94/7 has been incorporated into this Ruling and is now withdrawn.

Cross reference table of provisions

6. The following table cross references the provisions of the ITAA 1997 referred to in this Ruling and the corresponding provisions in the ITAA 1936:

ITAA 1997	ITAA 1936
section 6-5	subsection 25(1)
section 15-15	section 25A
Subdivision 20-B	section 26AAB
sections 20-110; 20-115; 20-125 and 20-160	subsection 26AAB(1)
sections 20-110; 20-125	subsection 26AAB(2)
section 20-120	subsections 26AAB(6); 26AAB(7) and 26AAB(8)
section 995-1	subsection 26AAB(14)
section 8-1	subsection 51(1)
sections 42-30	section 59
subsections 42-190(1) and 42-240(1)	subsection 59(2)
subsection 42-205, items 1 and 3	paragraph 59(3)(a)
subsection 42-285(1)	subsections 59(2A) and 62AAT(2)
section 42-290	subsections 59(2D) and 62AAT(2)
section 42-390	subsection 62AAT(1)
Parts 3-1 and 3-3	Part IIIA
subsection 104-15(1)	paragraph 160M(3)(d)
subsection 104-15(2)	subsection 160U(7)
section 118-20	subsection 160ZA(4)

Definitions

7. The meaning of key terms used in this Ruling are as follows:

'Balloon Payment' a payment made that has the effect of reducing subsequent payments under the agreement. Such a payment is usually made at the commencement of the lease, but can be structured into a lease at any time during the lease period;

'Deposit or Down payment' a payment made to reduce the cost of the asset which is the subject of the lease. In commercial terms the lessee has an equity in the asset; the lease terms reflect the balance of the cost of the asset after taking into consideration finance charges and the lease residual.

'Lease' a lease that satisfies the requirements of Taxation Ruling IT 28 and other related Taxation Rulings and Tax Determinations but does not include a hire purchase agreement.

'Prepayment' a payment in advance of rental payments for a specific period that is not a balloon payment (that is, it has not had the effect of reducing subsequent payments under the agreement);

'Trade-in Credit' the proceeds received or receivable from the trade-in of an asset net of any costs or charges directly associated with the trade-in.

Ruling

Whether trade-in credits form part of assessable income

8. Where a previously leased asset used for income producing or business purposes is traded-in on a replacement asset, all or part of the trade-in credit may be assessable under:

- (i) Subdivision 20-B (in the case of cars);
- (ii) sections 42-190; 42-240 or 42-390 if depreciation was allowed or allowable to the taxpayer prior to the trade-in and the trade-in credit exceeds the written down value. Relief from assessment of balancing adjustment amounts can be available in certain circumstances: see paragraph 11;
- (iii) section 6-5; or
- (iv) the capital gains tax provisions (except in respect of a car, motor cycle or similar vehicle: see section 118-5).

9. The trade-in credit is taken into account in working out taxable income under the applicable provision even though the proceeds are not paid to the lessee, but are used to reduce the cost of a replacement asset or to reduce the lease payments that would otherwise be payable on a replacement asset.

10. Where the trade-in credit comprises:

- (i) an amount representing the intrinsic or market value of the asset traded-in; and
- (ii) an amount in excess of the intrinsic or market value of the asset traded-in, being a subsidy or 'disguised discount' on the price of the new asset;

the 'disguised discount' component does not form part of the consideration taken into account in working out assessable income under sections 6-5, 42-190, 42-240, 42-390 or Parts 3-1 and 3-3, but constitutes a reduction in the cost of acquisition of the new asset.

11. Balancing adjustment relief under sections 42-285 or 42-290 may be available for balancing adjustment amounts that would otherwise be assessed under subsections 42-190 and 42-240 or 42-390. The otherwise assessable amount is treated as an amount deducted for depreciation of the replacement or other plant as at the first day of the income year in which the balancing adjustment event occurred.

Whether initial payments (balloon payments, prepayments and deposits or down payments) are tax deductible

12. The deductibility of payments under a lease for an asset used for income producing or business purposes depends on whether they are of a revenue, private or capital nature. For example, recurrent rental payments to secure the hire of an income producing asset are usually of a revenue nature. One-off payments to secure the use of an asset for an extended period of time or to reduce subsequent payments may be of a capital nature.

13. Where lease payments are of a revenue nature they are deductible when incurred except:

- (i) advance payments referred to in subdivision H of Division 3 of Part III (section 82KZL - 82KZO) of the ITAA 1936;
- (ii) payments to associates referred to in Subdivision D of Division 3 of Part III (section 82KH - 82KL) of the ITAA 1936;
- (iii) payments by employees subject to section 51AF of the ITAA 1936; or

- (iv) payments subject to Schedule 2E (leases of luxury cars) of the ITAA 1936.
14. Deductions for expenditure on rentals may be subject to the statutory rules applicable to deductible expenditure (for example, substantiation).
15. Lease payments of a capital nature are not deductible.
16. Where the payments are of a revenue nature and are not subject to the payments to associates rules, initial payments (balloon payments, prepayments and deposits or down payments) are deductible, subject to paragraph 12, as follows:
- (i) a balloon payment for the hire of an income producing asset for a period not exceeding 13 months that reflects the decrease in market value of the asset over the period covered by the payment is deductible when incurred;
 - (ii) a balloon payment that is not a subparagraph (i) payment is deductible subject to the application of section 82KZM of the ITAA 1936. Where section 82KZM applies, the deduction is spread over the lesser of the lease contract period or ten years;
 - (iii) a prepayment of the rentals for a period up to 13 months is deductible when incurred; or
 - (iv) a prepayment of rentals for a period of over 13 months, is deductible, subject to section 82KZM of the ITAA 1936, over the lesser of the lease contract period or ten years.
17. Certain other categories of initial payments are not, in general, tax deductible; for example:
- (i) the leasing arrangement contains a deposit or down payment, with the lease being to finance the balance of the cost of the asset; or
 - (ii) the terms of the lease and the extent of the lease payments do not accord with generally accepted commercial practice but are designed to obtain a tax advantage for the parties, particularly where the parties are not dealing with each other at arm's length (see Taxation Rulings IT 2317 and IT 2395).

Date of effect

18. In relation to subparagraph (i) of paragraph 16 of this Ruling, the Ruling only applies prospectively from 24 June 1993, being the date of

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release of Taxation Determination TD 93/119. In relation to all other aspects of this Ruling, the Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Trade-in credit assessable

Trade-in of a car - Subdivision 20-B

19. Subdivision 20-B recoups deductions in respect of a lease of a car recovered by the taxpayer through the subsequent purchase and resale of the car.
20. Unless one of the exceptions apply, subdivision 20-B applies if:
 - a car designed mainly for carrying passengers (a car) has been leased to the lessee or an associate of the lessee as defined in section 995-1 (referred to in this Ruling for brevity as 'lessee');
 - part or all of the lease payments have been allowed as a deduction from the assessable income;
 - the lessor has disposed of the car to the lessee; and
 - the lessee has disposed of the car for a profit, i.e., the consideration receivable by the lessee exceeded the cost of the car to the lessee plus any capital expenditure incurred after acquisition (see sections 20-110, 20-115, 20-125 and 20-160).
21. If a car is traded-in by the lessee in connection with the acquisition of another car, the consideration receivable is the sum of the amount by which the cost of the acquisition of that other car was reduced and any other consideration. Thus, if the lessee received a reduction in the cost of the replacement asset, the lessee would be treated as if it had received those amounts (see 'working out "consideration receivable" ' in subsection 20-115(2)).
22. The lessee should include in its assessable income under sections 20-110 and 20-125, to the extent that it does not exceed the lowest of the following amounts:
 - the amount of depreciation the lessee could have deducted on the car during the lease period (the notional depreciation);

- the lease payments allowed or allowable as deductions to the lessee; or
 - in the case of an associate acquiring the vehicle from the lessor - the amount by which the consideration receivable by the taxpayer on disposal of the car exceeds the car's cost to the associate and any capital expenditure incurred by the associate.
23. Notional depreciation for the lease period represents:
- the amount the lessee could have deducted for depreciation for the car if, instead of leasing it, the lessee has owned it and used it solely for the purpose of producing assessable income for that period:
- adjusted by:
- any balancing adjustment that would have been made if the lessee had disposed of the car at the end of the lease period.

Balancing adjustment - sections 42-190, 42-240 or 42-390

24. Where the lessee has used the asset for some time after purchasing it, and depreciation has been allowed or is allowable to the lessee, the trade-in credit is subject to the normal depreciation provisions and the capital gains tax provisions (Parts 3-1 and 3-3), where applicable.

25. The difference between the termination value in respect of the disposal and the written down value of the asset, up to the amount allowed or allowable as a depreciation deduction, should be included in the assessable income of the lessee under sections 42-190, 42-240 or 42-390. The otherwise assessable amount is now treated as an amount deducted for depreciation of the replacement or other plant as at the first day of the income year in which the balancing adjustment event occurred.

26. The term 'termination value' means, in the case of the sale by the lessee, the sale price less the expenses of the sale (see section 42-205, items 1 and 3). Taxation Rulings IT 87 and IT 278 provide that where the trade-in credit is equivalent to the intrinsic (or market) value of the property traded-in, the trade-in credit should be treated as the sale price. Where there is evidence that a trade-in credit was in excess of the (market) value of the property traded-in, the excess is regarded as a 'disguised discount' and the cost price of the new property should be reduced by the amount of the excess. In such circumstances, the 'sale price' of the property traded-in, for the purposes of section 42-205, items 1 and 3, is the market value of the property.

27. If a taxpayer has traded-in an asset without receiving a cash amount, but has received either a reduction of the cost of the replacement asset or a reduction of the lease payments on the replacement asset, the money value of that 'termination value' in terms of sections 42-190, 42-240 or 42-390 is deemed to have been paid or given to the taxpayer under section 21 of the ITAA 1936.

28. Any amount in excess of the amount assessable under sections 42-190, 42-240 or 42-390 is assessable under the capital gains tax provisions, unless the traded-in asset is a car, motor cycle or similar vehicle (see section 118-5).

29. If the 'termination value' on the trade-in is not specifically assessed under either Subdivision 20-B or sections 42-190, 42-240 or 42-390, the profit, that is, the difference between the trade-in credit and the residual value paid for the leased asset, may be assessable under Parts 3-1 and 3-3, where applicable (see paragraphs 40 to 48), or section 6-5.

Profit assessable - section 6-5

30. In the case of a previously leased asset, frequently the acquisition cost (residual or payout figure) is less than the market value. If the asset is subsequently disposed of by way of trade-in, at its market value, there is a profit or gain derived on disposal. This would be regarded as assessable income under section 6-5 where the profit:

- arose out of the lease of the asset in the course of the business; or
- has a direct nexus with, and arose out of, business operations; or
- is derived as an incident of the business (*Case C56* 71 ATC 247; (1971) 17 CTBR (NS) *Case 53*; *Case F1* 74 ATC 1; (1974) 19 CTBR (NS) *Case 19*; *Case N59* 81 ATC 304; (1981) 25 CTBR (NS) *Case 13*; *FC of T v. Reynolds* 81 ATC 4131; (1981) 11 ATR 629; *Case S34* 85 ATC 302; (1985) 28 CTBR (NS) *Case 42* and *Case X57* 90 ATC 428; *AAT Case 5996* (1990) 21 ATR 3463).

31. It has been suggested that the majority decision of the Full High Court in *AL Hamblin Equipment Pty Ltd; AL Hamblin Constructions Pty Ltd v. FC of T* (1974) 131 CLR 570; 74 ATC 4310; (1974) 5 ATR 16 (*Hamblin*) provides authority for the view that where there is no cash received on the disposal by way of trade-in of a previously leased asset (or an asset subject to hire purchase), and instead, the trade-in credit is applied to reduce the cost of purchasing, leasing or hiring a

replacement asset, then the surplus of the trade-in credit over the cost of the asset is not income under section 6-5.

32. However, we do not agree with this view of the decision in *Hamblin*. In *AL Hamblin Equipment Pty Ltd; AL Hamblin Constructions Pty Ltd v. FC of T* 74 ATC 4001; (1974) 4 ATR 208, Stephen J at first instance held the amounts involved in three of the four issues ultimately considered by the Full High Court were assessable under former paragraph 26(a) of the ITAA 1936. Subsection 25(1) of the ITAA 1936 (the equivalent of section 6-5) was not at issue and was not specifically addressed in the judgment except for one particular and peculiar issue, which was different in character to the typical trade-in situation.

33. In *Hamblin* Barwick CJ found at 131 CLR 576-577; 74 ATC 4314; 5 ATR 20:

'... that it is not proper to analyse the trade-in allowance as a price obtained on re-sale. In this respect I would not wish to add anything to what my brother Jacobs has written in his reasons for concluding that "the trade-in is not a sale at the price allowed on the trade-in". The reality of the situation is that the trade-in is a device to obtain a reduction in the effective price of the article to be acquired.'

34. We agree with the majority of the Court that a trade-in is not a sale at the price allowed on the trade-in. However, a trade-in is nonetheless a sale for money or money's worth as title or property in the goods pass, as Jacobs J said at 131 CLR 588; 74 ATC 4322; 5 ATR 29:

'... there is in law a sale, a transfer of goods for consideration in money or money's worth.'

35. In determining whether there is any profit or gain to be assessable under section 6-5 as a result of the sale of the asset by way of trade-in, Taxation Rulings IT 87 and IT 278 provide that, unless there is acceptable evidence a trade-in credit was in excess of the market value of the property traded-in, the trade-in credit would be treated as the sale price. This approach, in essence, treats the market price as the sale price for determining any assessable profit or gain.

36. Furthermore, Jacobs J, in arriving at his conclusion, analysed a simple trade-in situation as follows (131 CLR 587-588; 74 ATC 4322; 5 ATR 28-29):

'The seller of the new article will not give direct discounts on his price but he will accept an article in part payment of the purchase price and will place a value on it for that purpose above its market value. The proposing purchaser, let us say, goes to his local rubbish tip and selects an appropriate article which has

been abandoned there and by taking possession of it acquires title to it. He goes to the seller and offers it as a trade-in and the seller places a value on it well above its intrinsic value of nothing. He does this, as is well known, as a barely concealed discount against the price of the new article which is charged by him. Having acquired title to the article thus traded in he consigns it whence it came, the rubbish tip. Now I cannot conceive that the amount allowed by way of trade-in is assessable income of the purchaser of the new article.'

37. In the circumstances set out by Jacobs J, the cost of the article acquired and the intrinsic (or market value) of the article traded-in is nothing. There is no profit derived that could be regarded as assessable income. We agree that the trade-in allowance in excess of the market value is not assessable income of the purchaser of the new article, but a discount on the cost of the new article.

38. However, in the case of a previously leased asset, frequently the cost (residual or payout figure) is less than the market value. If the asset is traded-in at its market value, there is a profit or gain. This profit or gain is assessable income under section 6-5 if it is derived as an incident of, or in the ordinary course of, the business of the taxpayer.

39. In *Hytco Hiring Pty Ltd v. FC of T* 92 ATC 4216; (1992) 23 ATR 270; *Case T54* 86 ATC 419; (1986) 29 CTBR (NS) *Case 55* and *Case W88* 89 ATC 756; *AAT Case 5345* (1989) 20 ATR 3970, previously leased plant was acquired and used for a period of time in the business of the taxpayers. The plant was depreciated during the period of usage and depreciation recouped was returned as assessable income under subsection 59(2) of the ITAA 1936 (the equivalent of sections 42-190, 42-240 or 42-390). In these cases, it was held that subsection 25(1) of the ITAA 1936 (the equivalent of section 6-5) was not applicable to the profit being the difference between the sale price and the cost of the property for depreciation purposes. The profit was on capital account.

Profit assessable - Parts 3-1 and 3-3

40. In the cases mentioned in paragraph 39 the relevant assets were acquired prior to the enactment of Part IIIA of the ITAA 1936, which was replaced by Parts 3-1 and 3-3. Where assets acquired after 20 September 1985 are traded-in, any capital gains may be subject to the provisions of Parts 3-1 and 3-3.

41. A car, motor cycle or similar vehicle is an exempt asset and is, therefore, excluded from the application of the capital gains rules (see subsection 118-5). A car is defined in section 995-1 to mean a:

'motor vehicle (which is also defined in section 995-1 to mean "any motor-powered road vehicle (including a 4 wheel drive vehicle)" (except a motor cycle or similar vehicle) designed to carry a load of less than 1 tonne and fewer than 9 passengers.'

42. For purposes of Parts 3-1 and 3-3, the asset is usually acquired at the time at which the lessor and lessee agree to the transfer of the leased asset upon payment of the payout figure, where the transfer occurs during the term of the lease, or the residual, where the transfer occurs upon completion of the lease term.

43. In *Case X81* 90 ATC 594; *AAT Case 6253* (1990) 21 ATR 3703, a truck was leased in January 1983 (prior to the introduction of the CGT legislation). The lease agreement was in the standard form and included no express provision for the lessee to acquire the asset at the completion of the lease term. In March 1986 (after the CGT legislation was enacted) the residual was paid out. The truck continued to be used in the taxpayer's business until May 1987, when it was sold for an amount in excess of its cost.

44. The question at issue was whether the excess over the cost price was subject to tax by virtue of the former Part IIIA of the ITAA 1936.

45. It was argued by the taxpayer that acquisition should be taken to have occurred at the time that the taxpayer, as lessee, first obtained use or possession of the asset under the lease, by operation of subsection 160U(7) of the ITAA 1936 (the corresponding provision to subsection 104-15(2)). As this was prior to the introduction of Part IIIA, the excess over the cost price would not have been subject to tax under that Part.

46. The Tribunal found that the absence in the lease agreement of an express right in the lessee to acquire the title in the relevant asset during the term of the lease or upon its termination, meant the lease could not be regarded as a transaction pursuant to which '... title to the asset will or may pass ...' to the lessee.

47. The Tribunal further observed that the existence of an entitlement to acquire the asset under the lease agreement would have resulted in the purported 'lease' transaction being regarded instead as one of 'hire purchase'. This aspect of the decision in *Case X81* is consistent with the Commissioner's view as expressed in Taxation Ruling IT 28 and related Rulings.

48. It should be noted that, under section 118-20, any capital gain derived is reduced by any amount that has or will be included in assessable income of the taxpayer, for example, an amount assessable under section 6-5.

Tax deductible initial payments

49. The deductibility of payments under a lease depends on whether the payment is of a revenue, private or capital nature. The nature of the payment is a question to be determined having regard to the facts and circumstances of the particular case. A number of factors have been used by the courts in determining the nature of such expenditures. For example, in *FC of T v. Creer* 86 ATC 4318; (1986) 17 ATR 548, the following factors were referred to by the court in determining the true character of the payment:

- (a) the character of the advantage sought;
- (b) the manner in which it is to be used;
- (c) the means adopted to obtain it; and
- (d) the advantage sought by the making of the payment.

50. In *Creer's* case, the taxpayer prepaid total rent for a five year lease in three annual instalments, with the first instalment being 80% of the total rent. The Full Federal Court were of the view that, although periodic rentals are ordinarily of a revenue nature, a lump sum payment of, or instalment payments of, total rentals were of a capital nature in the circumstances of the case.

51. The tax deductibility of some specific payments is discussed in the following paragraphs. This discussion is subject to paragraph 49 and provisions generally applicable to deductions for expenditure (for example, substantiation).

Balloon payments

52. A lease payment of a revenue nature that is high in relation to subsequent payments under the lease is deductible when incurred if it merely reflects the decrease in value of an item over the specific period covered by the payment. The period must not exceed 13 months.

53. An example is where a new car is driven off the showroom floor. The vehicle immediately drops in value to reflect the value of the vehicle on the used car market. If the initial rental payment is higher than subsequent payments to reflect this decrease, with the other rental payments remaining constant, then the payment would be deductible - see Taxation Ruling IT 2395.

54. However, where the period to which the payment relates exceeds 13 months, the amount deductible is subject to the advance payment rules in sections 82KZL to 82KZO of the ITAA 1936.

55. Section 82KZM of the ITAA 1936 applies to expenditure incurred in return for the doing of something under an agreement that will not be completed within 13 months after the day the expenditure is incurred. Where the provision applies, the deductibility of the expenditure is apportioned over the lesser of the income years in the period to which the payment relates, or ten years.

56. In addition, a balloon payment made that results in a reduction in subsequent rental payments required during the lease term would be deductible where the total payments, that is, the balloon payment and the rental instalments, are calculated on the basis of the total cost of the leased asset (not the cost of the asset minus the balloon payment).

57. In these circumstances, the balloon payment would be deductible, subject to the provisions of section 82KZM of the ITAA 1936, in addition to the reduced monthly lease payments (see Example 5 of this Ruling).

Prepayments - also see Taxation Ruling IT 2317

58. A payment made to prepay monthly rental payments, without reducing the level of subsequent rental payments, but obtaining a corresponding 'lease payment holiday period', would be deductible, subject to the operation of section 82KZM of the ITAA 1936 (see paragraph 55).

59. Where the prepayment of lease instalments is for services that are to be provided (that is, use of the leased asset) within 13 months from the date of the payment, section 82KZM does not apply. A payment made in these circumstances would be deductible in full.

60. On the other hand, a prepayment of more than 13 monthly rental payments would be deductible subject to the provisions of section 82KZM. That is, the payment would be apportioned over the lesser of 10 years or the period to which the payments relate.

Deposit or down payment

61. If the payments to the lessor on the replacement asset are calculated by reference to the cost of the replacement asset minus the trade-in credit, the credit constitutes a deposit, instalment or down payment of a capital nature to acquire the asset.

62. In addition, the payments under the lease would constitute instalments of a capital nature because they are not payments for hire of the asset but payments to discharge the amount advanced by the lessor under the arrangement to acquire the asset.

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63. In any event the arrangement may not constitute a 'lease' as defined in paragraph 7 above for two reasons:

- (i) the residual value determined under the lease is based on the net cost of the asset, and this does not conform with Taxation Ruling IT 28 or Taxation Determination TD 93/142; and
- (ii) the lessee, in essence, has an 'equity' in the asset.

64. This latter concept is best explained by way of example. If the replacement leased asset was worth \$80,000 (after allowance of any discount or 'disguised discount') and the trade-in credit was \$40,000, the lessee could be paid a cash amount of \$40,000, and then lease the replacement asset at its full value of \$80,000. In these circumstances, the lease payments would be the same as if no trade-in had occurred and would not affect the validity of the lease.

65. Alternatively, the \$40,000 trade-in credit might be used to reduce the 'cost' of the replacement asset, with lease payments calculated as if the newly leased asset were worth only \$40,000. Normally, this would mean the lease payments would be calculated so that, over the term of the lease, they equated to \$40,000 minus the residual value of the asset at the end of the lease plus interest on the difference.

66. In these circumstances, the arrangement would not constitute a lease. The lease payments would be less than would normally be payable in a commercial lease of the asset. Looked at another way, the lessee has already paid for part of the cost of the asset. In commercial terms, the lessee has acquired some 'equity' in the asset.

67. In this situation, the trade-in credit has been used to pay for part of the cost of the asset, and the lease payments are calculated by working out the interest payable on the difference between that reduced amount and the residual value of the asset at the end of the lease.

Inflated initial rentals and nominal later rentals

68. If the lease rental payments to be made during the early stages of a lease are high, while during the later years of the lease, payments are lower than commercial rates or purely nominal, it indicates the payments are capital in nature and not deductible. Similarly, where plant and machinery is leased for a comparatively short initial period at a high rate of rental, with a provision for renewal at a nominal rental for a further period that corresponds with the remaining useful life of the unit, it indicates the lease payments are capital in nature and not deductible. These conclusions are based on an assumption that the

periodical payments required to be made in relation to both the early or initial lease period and subsequent rental periods are not commercial.

Examples

Example 1: *Disposal of car to which Subdivision 20-B applies*

69. The facts are:

- (i) a car is leased from 1 July 1997 to 30 June 1998, and is used wholly for income producing purposes by the lessee. At the end of the lease the lessee purchased the car at its residual value of \$20,000 and sold it for \$25,000;
- (ii) cost of the car to the lessor - \$30,000;
- (iii) lease payments deductible to lessee - \$20,000;
- (iv) residual value and termination value - \$20,000;
- (v) consideration receivable - \$25,000.

70. The notional depreciation that would have been allowable to the lessee is \$10,000 - the cost of the car to the lessor of \$30,000 minus the termination value of \$20,000.

71. Under sections 20-110 and 20-125, the lessee is assessable on the amount by which the consideration receivable exceeds the cost of the property to the lessee, to the extent that that amount does not exceed the notional depreciation or the allowable lease payments. In other words, the lessee is assessed on the lowest of the three following amounts:

- (i) excess of consideration receivable over cost of property - \$25,000 minus \$20,000 = \$5,000;
- (ii) notional depreciation - \$10,000;
- (iii) allowable lease payments - \$20,000.

In this Example, the lessee will be assessed on \$5,000.

Example 2: *Asset acquired for its residual value and depreciated by the lessee*

72. A truck is leased and, at the end of the lease, purchased by the lessee and used for 6 months for income-producing purposes. It is then traded-in on a replacement truck. The truck was purchased after 26 February 1992 for its residual value of \$30,000. It was traded-in for \$40,000.

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73. The taxpayer chose not to create a 'pool' or allocate the truck to an existing 'pool' and to depreciate the truck using the diminishing value method using the 30% depreciation rate for the 6 month period.

Depreciation allowable - $\$30,000 \times 30\% \times 50\%$ - \$4500

Written down value - \$25,500.

74. As the termination value on the disposal of the truck exceeded the truck's written down value, the \$4,500 is assessable under section 42-190 or may be offset against other depreciable assets under sections 42-285 or 42-290.

75. The remaining \$10,000 profit is taxable under the capital gains tax provisions. As the asset was acquired by the taxpayer less than 12 months prior to the disposal, the cost base is not indexed for inflation.

Example 3: Treatment of profit on non-car trade-in

76. An asset that is not a car is leased for 3 years and then traded-in on a replacement asset that is also leased. The lessee is paid \$4,000 in cash for the first leased asset. \$2,000 of this money is used to pay the residual value of that asset.

77. The \$2,000 profit on the transaction is assessable to the lessee.

Example 4: Equity transfer or replacement lease

78. An asset, a truck, is leased. Its market value is \$20,000 at the end of the lease term. Its residual value is \$10,000. A replacement truck worth \$100,000 is to be leased.

79. The lessee does not pay the residual value to the lessor to acquire the leased truck, or receive directly the difference between the market value and the residual value of the truck. Instead, the cost of the replacement truck for the purposes of the new lease is adjusted to take into account these amounts.

80. This type of transaction has been variously described as an equity transfer or as a replacement lease:

cost of replacement truck	\$100,000
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deduct:

amount credited equivalent to the 'equity' the lessee had in the truck represented by the difference between the market value and residual	<u>\$ 10,000</u>
value of replacement truck for lease purposes	<u>\$ 90,000.</u>

81. The lessee is treated as if it had received consideration of \$10,000 on the original truck. This amount is assessable in full.

82. The new lease is not treated as a lease for taxation purposes. The lessee is treated as if the replacement truck is being purchased. The cost of the replacement truck for depreciation purposes is \$100,000.

Example 5: Trade-in profit used to reduce lease rental payments

83. A previously leased car is traded-in on 1 January 1993 immediately after the payment of the residual prescribed in the lease agreement.

84. The profit (trade-in credit less the residual) resulting from the transaction is \$10,000.

85. Another vehicle is leased for 4 years. This vehicle is used 100% for business purposes as was the original vehicle.

86. The \$10,000 profit is used to make a lump sum prepaid rental payment that reduces the 48 monthly lease rental payments from \$364.33 (\$4,372 per annum) to \$156 (\$1,872 per annum). The reduced lease rental payments are calculated on the basis of total cost of the leased asset, not the cost of the asset minus the balloon payment.

87. The profit of \$10,000 is to be included in assessable income of the year ended 30 June 1993 by virtue of Subdivision 20-B.

88. Also, the \$10,000 prepaid rental payment is deductible over the term of the lease in accordance with section 82KZM of the ITAA 1936. This deduction is additional to the monthly rental payment incurred.

89. The total deduction available each year is made up of the sum of the following amounts:

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Year	Annual payment	Proportion of prepayment	
30 June 1993	\$..936	\$ 1239	(\$10,000 x 181/1461)
30 June 1994	\$1872	\$ 2498	(\$10,000 x 365/1461)
30 June 1995	\$1872	\$ 2498	(\$10,000 x 365/1461)
30 June 1996	\$1872	\$ 2505	(\$10,000 x 366/1461)
30 June 1997	<u>\$ 936</u>	<u>\$ 1260</u>	(\$10,000 x 184/1461)
	<u>\$7488</u>	<u>\$10,000</u>	

Example 6: Use of trade-in profit to prepay less than 13 months lease instalments

90. Mr Lee Sea entered into a 5 year lease on 1 July 1992, with monthly lease instalments of \$1,000. From July 1992, Mr Sea pays \$1,000 each month under the lease agreement. However, in June 1993 he decides to make a prepayment of lease instalments. Accordingly, he pays \$13,000 being \$1,000 for the June 1993 instalment and \$12,000 being a prepayment for the next 12 months. In July 1993 and subsequent months, Mr Sea continues to pay instalments of \$1,000 12 months in advance. During the 1996/97 financial year, the year the lease is due to expire, Mr Sea does not have to make any lease payments - they have been prepaid (referred to as a 'holiday period').

91. Under these circumstances, section 82KZM of the ITAA 1936 does not apply to the prepayment.

92. The \$12,000 represents a prepayment of lease instalments up to June 1994. As Mr Sea has incurred the expenditure in relation to services that are to be provided within 13 months (that is, use of the leased asset), section 82KZM has no application. The same principle applies to subsequent monthly instalments. For example, the monthly payment made in July 1993 is, in effect, a prepayment for the July 1994 lease instalment. This payment is also for services to be provided within the 13 month time limit specified in section 82KZM and, therefore, the section does not apply.

Detailed contents list

93. Below is a detailed contents list for this Ruling:

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