International taxation of cross-border leasing income
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CHAPTER 1
INTRODUCTION

Background

Businesses seem to have recognized that they derive value by using assets, and ownership of assets may be incidental. For instance, on 1 February 2004 the *International Tax Review* journal reported that BT Group, a British telecom company, recently carried out a GBP 1.3 billion (USD 2.37 billion) sale-and-leaseback transaction that could cut the company’s tax liabilities by as much as GBP 300 million (USD 546 million) over a number of years.¹

It is not surprising that, globally, the volumes of leasing transactions have grown steadily over the last few decades. For instance, in 2003, the aggregate value of leasing transactions in the United States amounted to USD 208 billion, representing 31% of the total value of all productive assets acquired by US businesses;² that figure is estimated to be USD 218 billion for 2004. As per the Equipment Leasing Association (US), 80% of the US companies lease all or some of their equipment. In Japan, in 2002, the aggregate value of the leasing transactions amounted to over JPY 7,374 billion (approximately USD 67 billion), representing 9.25% of the total private investment.³ In Europe, in 2003, the aggregate value of leasing transactions in 26 countries amounted to about EUR 194 billion, including EUR 44 billion in Germany (representing 18.08% of the total investment in new assets), EUR 32.15 billion in Italy (13.61%), EUR 32.82 billion in the United Kingdom (13.75%) and EUR 26.03 billion in France (19.62%).⁴

Importance of tax aspects in leasing transactions

A preliminary investigation revealed that the tax advantage of leasing constitutes one of the key reasons for businesses often preferring leasing to

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¹ The UK arm of the Société Générale Bank bought the equipment from BT Group, and agreed to lease it back for five years.
² Source: Equipment Leasing Association (US). The value of total productive assets acquired by the American businesses in 2001 amounted to USD 697 billion.
³ Source: Japan Leasing Association.
⁴ Source: Leaseurope.
conventional loan for financing asset acquisition. For instance, among key reasons for companies’ preference for leasing, the Equipment Leasing Association (US) states as follows:

Companies are incented to invest in new equipment by the federal and state tax codes. But often the companies cannot use these incentives. Through the use of leasing, however, the benefit of the incentive can be passed on through a company in low rental payments because as the owner of the equipment, the leasing company utilized the depreciation or credit incentive.5

It is discernible that, in harmony with the above-quoted statement, a survey conducted by the Japan Leasing Association in 2000 revealed that leased equipment costs less than borrowing money to purchase it.6

**Leasing: the cross-border dimension**

When I began working on a leasing research assignment at the International Bureau of Fiscal Documentation in year 2001, the relevant material revealed that the diversity among tax laws of various countries may amplify the tax advantages of leasing in a cross-border situation, as compared to the tax advantages of a leasing transaction within a country (domestic leasing). For instance, in a cross-border leasing ("double-dip") transaction, both the lessor as well as the lessee may be entitled to depreciation allowance due to peculiar features of the tax law in their respective jurisdictions. Also, parties to a cross-border lease may attempt to exploit the beneficial provisions of tax laws of the lessor’s country, although the underlying legislative intent of the said provisions may have been only to grant a benefit in the case of a domestic lease.

**Research objective and structure of the thesis**

Generally, a taxpayer may be able to obtain a tax advantage by resorting to one or more of the following techniques:
- minimizing the gross amount of taxable income (vis-à-vis the amount of gross revenue);
- maximizing the aggregate amount of tax deductions;

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Researchers and structure of the thesis

- deferring the taxability of income; and
- in the case of cross-border transactions, minimizing source country taxation (besides the residence country taxation).

This study seeks to investigate, specifically, how the parties to a cross-border leasing transaction may be able to obtain tax advantages under the relevant tax laws and tax treaties of Germany, Japan, the Netherlands, the United Kingdom and the United States (hereafter referred as "the select jurisdictions"). The study also aims to investigate whether, and how, the various anti-avoidance provisions under the relevant tax laws may prevent parties to cross-border leasing transactions from obtaining undue tax advantages. For these purposes, the study is divided in the following seven areas:

(i) Lease characterization aspects

As tax consequences of a lease substantially depend upon characterization of the transaction (as sale, finance lease, or operating lease). As the starting point of the study, the lease characterization aspects under the relevant national tax laws of the select jurisdictions are examined in chapter 2.

(ii) Tax depreciation on leased assets

Generally, tax depreciation on the leased asset constitutes one of the most substantial items of deduction in computing a lessor's taxable income in the residence state. Often, in the early years of the lease term, the excess of allowable tax depreciation over the gross lease rental income results in a tax loss for the lessor, which enables the lessor to postpone his tax liability on the lease rentals, and to set off the said loss against other taxable income. Usually, the said advantage derived by the lessor is effectively passed on to the lessee by way of reduced lease rentals. Accordingly, the lessors' (and in some cases the lessees') entitlement to depreciation allowance forms the central element in many lease transactions. Aspects relating depreciation entitlement under the relevant national tax laws of the select jurisdictions are dealt with in chapter 3.

(iii) Income recognition/deferral aspects

A lessor may be able to defer tax liability in respect of leasing income by rear-loading the lease rentals. However, the tax laws of many countries

8. I.e. by receiving a greater part of the total lease rentals in the later part of the lease term.
may contain specific anti-avoidance provisions designed to prevent tax deferral by lessors. These aspects are examined in chapter 4.

(iv) Transaction structures and the effect of anti-avoidance rules in national tax legislation

To neutralize aggressive leasing transactions, tax laws of many jurisdictions include specific restrictive or anti-avoidance provisions. However, the players in the leasing arena are often successful in innovating transactions that are well beyond the said restrictive or anti-avoidance provisions. Such innovations are often followed by consequential amendments in the national tax laws to plug “newly discovered” loopholes. This seemingly unending “legislative amendment – transaction innovation sequence” leads to continuous evolution of new transaction structures. Chapter 5 deals with aspects relating to various tax-driven leasing transaction structures, such as sale and leaseback, double-dip leasing, leveraged leases, etc., designed to maximize tax advantages from leasing, as well as the relevant general and specific anti-avoidance rules (including court decisions, if any) under the relevant domestic tax laws.

(v) Income characterization issues under tax treaties

Chapter 6 begins with an overview of the OECD position on definition of the term “royalty” vis-à-vis lease rental income in respect with industrial, commercial and scientific equipment (ICS equipment) and the divergent position concerning taxation of royalty income in various tax treaties. Thereafter, the chapter focuses on the characterization issue: whether and how characterization of income from a lease transaction may influence applicability (or non-applicability) of the tax treaty distributive rules, particularly the articles concerning royalties, interest and business profits.

(vi) Tax treaty aspects of source-state taxation of cross-border leasing income

Chapter 7 analyses the following issues:

- How various tax treaties differ in provisions concerning taxation of royalties, interest income and capital gains that may provide tax arbitrage opportunities in respect of cross-border leasing transactions.

- Whether an interposed leasing entity carrying on substantive leasing business activities should qualify for benefits under a tax treaty of its
Research objective and structure of the thesis

residence state. For this purpose, it is important to note that, since the issue of applicability of a tax treaty in case of “improper” use by residents of a third country (“treaty shopping”) could be a subject matter of another doctoral research project by itself, the same is not investigated in detail for the purposes of the present research. However, in view of the fact that, often, investors resident in third countries may own equity capital of a lessor, the contemporary position on the issue is taken into account.

- What is the function of the “beneficial ownership” requirement observed in contemporary tax treaties?

- What would be the implication of absence of “beneficial ownership” requirements in a tax treaty? For instance, Germany’s tax treaties with Australia and Japan do not contain a “beneficial ownership” requirement. For this purpose, it is important to note that the present study focuses on the consequences of absence (compared to presence) of a “beneficial ownership” condition in a tax treaty; detailed analysis of the meaning of the term “beneficial owner” is beyond the scope of this study.9

(vii) Relevance of EC Treaty freedoms

The penultimate chapter (chapter 8) takes into account how the framework of EC Treaty freedoms may be relevant for cross-border leasing transactions within EC Member States.

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