International taxation of cross-border leasing income
Mehta, A.S.

Citation for published version (APA):

General rights
It is not permitted to download or to forward/distribute the text or part of it without the consent of the author(s) and/or copyright holder(s), other than for strictly personal, individual use, unless the work is under an open content license (like Creative Commons).

Disclaimer/Complaints regulations
If you believe that digital publication of certain material infringes any of your rights or (privacy) interests, please let the Library know, stating your reasons. In case of a legitimate complaint, the Library will make the material inaccessible and/or remove it from the website. Please Ask the Library: http://uba.uva.nl/en/contact, or a letter to: Library of the University of Amsterdam, Secretariat, Singel 425, 1012 WP Amsterdam, The Netherlands. You will be contacted as soon as possible.
CHAPTER 2

TRANSACTION/LEASE CHARACTERIZATION ASPECTS

2.1. Introduction

As the tax treatment (for the lessor and the lessee) in respect of depreciation allowance as well as gross taxable income\(^\text{10}\) is dependent upon transaction characterization (as lease v. sale), the characterization issue could be viewed as the central issue concerning taxation of leasing income.

Sections 2.2. to 2.6. deal with the aspects relating to characterization of lease agreements in the United States, the United Kingdom, Germany, the Netherlands and Japan.

2.2. Lease characterization in the United States

2.2.1. True lease: prerequisite for obtaining the tax advantage

In the United States, for the lessor to secure the tax benefits associated with the ownership of the leased asset (mainly the depreciation deduction), the lease must qualify as a "true lease".\(^\text{11}\) If the lease transaction is viewed as a conditional sale or a secured loan, the lessee would be considered as the owner of the lease equipment and hence would be entitled to the tax benefits associated with the ownership of the leased equipment. This may nullify the tax advantages of a leasing transaction.

For a transaction to qualify as a true lease, generally, the following two conditions must be satisfied:\(^\text{12}\)

\(^{10}\) I.e., taxability of the entire amount of the gross lease rentals vis-à-vis taxability of only the finance income part out of the gross lease rentals.


Chapter 2 – Transaction/lease characterization aspects

- the lessor must sufficiently retain the benefits and burdens typically associated with the ownership of the leased asset (facts-and-circumstances analysis);\(^{13}\) and
- the lessor must have a non-tax profit motive for entering into the transaction (pre-tax profit motive)

2.2.2. The IRS view

2.2.2.1. Revenue Ruling 55-540: IRS view on what constitutes a "true lease"

In 1955, the Internal Revenue Service (IRS) issued Revenue Ruling 55-540 clarifying its position as to when it would regard a lease transaction as a "true lease", and when it would regard a transaction as purchase and sale of property.

As per the said Revenue Ruling, whether, in substance, a transaction is a lease or a conditional sales contract depends upon the intent of the parties as evidenced by the provisions of the contract, viewed in light of the facts and circumstances existing at the time the transaction was executed.\(^{14}\)

The Revenue ruling states that in absence of compelling persuasive factors of contrary implication, a transaction would be regarded as a transaction of purchase and sale (and not lease), if one or more of the following conditions are present:
- portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee;
- the lessee will acquire title (in the leased property) upon the payment of a stated amount of "rentals";
- for a relatively short period of use, the lessee is required to pay an inordinately large proportion (out of the total amount required to be paid

\(^{13}\) On this aspect, also see Orticelli, David J., “Structuring Techniques For Generating Active Foreign Leasing Income”, *Journal of International Taxation* September 1998.

under the contract), which could be considered a payment for securing the transfer of the title;

- the agreed “rental” payments materially exceed current fair market rental value, which may indicate that the payments include an element other than compensation for the use of the asset;

- the lessee is entitled to acquire the leased asset under a purchase option at a price which is (i) nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or (ii) a relatively small amount as compared to the total amount payable by the lessee;

- a part of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.

The Ruling also states that the fact that the agreement makes no provision for the transfer of title or specifically precludes the transfer of title does not, by itself, prevent the contract from being regarded as sale of an equitable interest in the property.

On the other hand, the Ruling states that transactions would usually be in the nature of lease (rather than purchase and sale of property) if the rental payments are at an hourly, daily, or weekly rate, or are based on production, use, mileage, or a similar measure and are not directly related to the normal purchase price, provided, if there is an option to purchase, that the price at which the property may be purchased reasonably approximates the anticipated fair market value on the option date.

It is interesting to note that the Ruling does not state that a transaction would be regarded as a sale (instead of lease), if the lease term approximates the estimated useful life of the asset.

2.2.2.2. Revenue Procedure 75-21: Detailed Guidelines for granting advance rulings

For facilitating issuance of advance rulings on whether a purported lease transaction should be treated as lease for federal income tax purposes, the IRS promulgated general guidelines through Revenue Procedure 75-21,
Chapter 2 – Transaction/lease characterization aspects


As such, the old Guidelines applied only to “leveraged” leases and did not define, as a matter of law, as to when a transaction constituted a lease for federal income tax purposes. However, the IRS indicated that a transaction that complies with the old Guidelines should be treated as “lease” in course of audit.16

As per the old Guidelines, for a transaction to be respected as lease, the following conditions must be satisfied:

(a) Minimum 20% equity investment requirement

The lessor must make an initial equity investment in the leased asset equal to at least 20% of the cost of the asset and maintain a 20% equity investment throughout the lease term.17 The initial equity investment may be either in the form of consideration paid or personal liability incurred by the lessor. In the case of the personal liability of the lessor, the lessor must have sufficient net worth to satisfy the liability.

The equity investment must be unconditional, and therefore the lessor must not be entitled to the return of any portion of the said minimum investment, after the leased property is first placed in service, through any direct or indirect arrangement with the lessee or any member of the lessee group. However, the old Guidelines did not prohibit an arrangement between the lessor and a third party (other than a member of the lessee group) for return of the lessor’s minimum equity investment, if the leased property did not satisfy the written specifications for the supply, manufacture or construction of the property.

17. Rev. Proc. 75-21, Sec. 4(1)(A).
(b) **Minimum 20% residual value and remaining useful life**

The old Guidelines required that at the end of the lease term, as a reasonable estimate, the fair market value of the leased property must be at least 20% of its original cost. Further, at the end of the lease term, the leased property must still have at least 20% of its total estimated useful life. For this purpose, the term “lease term” included all renewal periods except renewals at the option of the lessee at fair rental value determined at the time of renewal.

(c) **Fixed-price purchase/sale option**

The old Guidelines required that the lessee should not have an option to purchase the leased property for a price less than the fair market value of the property at the time of exercise of the option. Similarly, the lessor should not have a right to cause any party to purchase the leased property (even at the fair market value) or to abandon the property to any party.

(d) **Lessee not to finance any part of the cost of the property**

As per the old Guidelines, no part of the cost of the leased property must be funded by the lessee or any member of the lessee group.

Also, the property must not require either a severable or non-severable improvement to the leased property by the lessee at the inception of the lease (except the ancillary items that are customarily furnished by the lessee or the purchaser of the property). Also, any severable improvements made by the lessee must not be subject to a purchase contract or option between the lessee and the lessor at a price other than the fair market value at the time of implementation of such contract or exercise of such option. Also, as per the Guidelines, the lessee may not make non-severable improvements that exceed certain specified threshold or type, and the lessee may not obtain an equity interest in any allowable non-severable improvement made by it.

(e) **Lessee not to provide any loan or guarantee**

None of the members of the lessee group must lend to the lessor any part of the funds needed to acquire the leased property, or provide a guarantee in respect of any indebtedness incurred by the lessor to purchase the leased property. However, recognition of the transaction as “lease” would not be jeopardized by a guarantee by a member of the lessee group in respect of the lessee’s rent obligations, maintenance, insurance or other similar obligations of the lessee in case of a net lease.
(f) Profits and cash flow

As per the Guidelines, the lessor must be able to demonstrate that he expects a pre-tax profit from the transaction. This requirement is satisfied if the lessor can demonstrate that the sum of the payments to be made by the lessee and the expected residual value of the leased property at the end of the lease term exceeds the sum of the aggregate disbursements required to be paid by/for the lessor and the lessor’s equity investment in the equipment including any direct costs to finance this equity investment.

The Guidelines also require that the lessor’s aggregate cash flow from the transaction must be positive.

2.2.2.3. Revenue Procedure 2001-28

On 7 May 2001, the IRS issued Revenue Procedure 2001-28 (“new Guidelines”), superseding the old Guidelines, for advance ruling purposes. In essence, the relevant features of the new Guidelines are similar to the features of the old Guidelines discussed at 2.2.2.2. However, interestingly, the new Guidelines deviate from the old Guidelines by stating that the new Guidelines are not intended to be used for audit purposes. Accordingly, the new Guidelines may be viewed as having a limited function of facilitating the process of advance rulings, rather than expressing the IRS view on characterization of transactions as lease or sale. Probably, this deviation (as compared to the old Guidelines) is due to the fact that, except the pre-tax profit requirement, the conditions of the old and the new Guidelines are not judicially enforceable, as the courts have disregarded the said conditions (see discussion at 2.2.3.). As the said conditions are not enforceable, the IRS could only refuse to issue an advance ruling in the case of a transaction not satisfying the conditions of the new Guidelines, though such a transaction may be eventually characterized as lease in accordance with the principles emerging from the various court decisions discussed in this chapter.

2.2.3. Judicial developments

2.2.3.1. Case law developments vis-à-vis the Guidelines requirements: a comparison

Transactions that deviated from all aspects of the old Guidelines have been regarded by courts as lease, except the pre-tax profit requirement,\(^{19}\) as can be observed from the discussion hereafter.\(^ {20} \) As the features of the new Guidelines are comparable to the old Guidelines, the said court decisions are equally relevant in context of the new Guidelines.

(a) Minimum 20% equity investment requirement

Compared to the Guideline’s requirement for the minimum 20% equity investment by the lessor, the courts have regarded as lease even the transactions that involved equity investments by the lessors ranging from mere 6% to 17%\(^ {21} \).

(b) Minimum 20% residual value and remaining useful life

Compared to the Guideline’s requirement for the residual value at the end of the lease term of at least 20% of the original cost of the asset, the tax court regarded as lease even a transaction with inflated residual value of 2%.\(^ {22} \) Also, in the same case, the tax court accepted the transaction as lease although the estimated useful life of the property at the end of the lease term did not exceed 16.67%.

(c) Fixed-price purchase/sale option

It appears that the courts recognize transactions with a fixed price purchase option (contrary to the Guideline) as lease, if the purchase price either represents a reasonable estimate of the fair market value of the leased property as of the option exercise date, or if the purchase price is not nominal in re-

---


21. 6% in *Emershaw v. Commissioner*, 59 T.C.M. (CCH) 621 (1990), aff’d, 917 F.2d 1040 (8th Cir. 1990); 9% in *L.W. Hardy Co. v. Commissioner*, 52 T.C.M. (CCH) 1540 (1987); 9% in *Lansburgh v. Commissioner*, 53 T.C.M. (CCH) 454 (1987); and 17% in *Greenbaum v. Commissioner*, 53 T.C.M. (CCH) 708 (1987).

Chapter 2 – Transaction/lease characterization aspects

... to such value. In one case, the tax court accepted as lease a transaction that included a put option for the lessor.

(d) Lessee not to finance any part of the cost of the property

The courts have recognized as lease transactions that involved investments by lessees (contrary to the Guideline).

(e) Lessee not to provide any loan or guarantee

The court recognized a transaction as lease where the lessee had guaranteed the lessor’s debt in connection with financing of the leased asset.

(f) Cash flow

In certain cases, courts have upheld as lease transactions in spite of the absence of net positive pre-tax cash flow, since it was found that the anticipated residual value of the leased property was adequate to lead to a net gain for the lessor.

Thus, the courts have upheld the lease transactions satisfying none of the criteria stated in the Guidelines, except the pre-tax profit motive aspect.

2.2.3.2. Court decisions on transaction characterization: lease v. sale

In the United States, although the IRC does not specify the conditions for characterization of a lease transaction, there is an extensive development of case law on the issue as to whether a “lease transaction” amounts to lease or conditional sale. Depending upon the particular facts and circumstances...

23. Transamerica Corp. v. United States, 88-2 U.S.T.C. (CCH); Lockhart Leasing Co. v. Commissioner, 446 F. 2d 269 (10th Cir. 1971); LTV Corp. v. Commissioner, 63 T.C. 39, 50 (1974); Northwest Acceptance Corp. v. Commissioner, 58 T.C. 836, 847-48 (1972).
25. 79% of the cost of the leased asset in Lansburgh v. Commissioner, 53 T.C.M. (CCH) 454 (1987); 85% in Mukerji v. Commissioner, 87 T.C. 926 (1986); 100% in Johnson v. United States, 86-2 U.S.T.C. (CCH).
in various cases, the courts have reached divergent conclusions. A review of the key court decisions reveals that the courts consider economic substance rather than the legal form of a transaction to characterize a transaction as a lease or a sale transaction.

The courts generally tend to respect a transaction as “lease”:

- if in the case of existence of a purchase option in favour of the lessee, the amount of lease rental payable during the lease term is reasonable (when considered strictly as rental), and the price at which the lessee is entitled to purchase the leased asset in future is not unreasonably low as on the date of signing the lease agreement;

- if a lease agreement does not confer a purchase option in favour of the lessee, and if the lessee eventually acquires the leased asset from the lessor, since such acquisition does not necessarily provide an inference that the lessee had a legal right as such to acquire the said equipment prior to its actual acquisition;

- if a purchase option in favour of the lessee, the predetermined purchase price (to be paid by the lessee to the lessor) is based on the expected value of the leased asset; in such a case mere presence of a purchase option in favour of the lessee is not in itself determinative factor and the rentals at standard rates do not necessarily represent recovery of the purchase price of the lease asset plus interest; or

- if the lease agreement does not confer a purchase option in favour of the lessee, and if the lessee is obliged to return the leased asset to the lessor after expiry of the primary lease term (or extended lease term in case of a renewal option available to the lessee), the lessee is precluded from disposing of the leased asset, the lessor realizes significant income from scrapping of the returned equipment and follows elaborate procedures for locating/identifying the leased equipment.

28. Summarized in Appendix 1.
29. Benton v. Commissioner of Internal Revenue, 197 F. 2d 745 (US Court of Appeals Fifth Circuit); The LTV Corporation v. Commissioner of Internal Revenue, 63 T.C. 39 (US Tax Court).
30. Western Contracting Corporation v. Commissioner of Internal Revenue, 271 F.2d 694 (US Court of Appeals Eighth Circuit).
31. Expected value of the leased asset as on the date of exercise of the purchase option, as expected at the time of entering into the agreement.
32. Lockhart Leasing company v. United States of America, 446 F.2d 269 (US Court of Appeals Tenth Circuit); The LTV Corporation v. Commissioner of Internal Revenue, 63 T.C. 39 (US Tax Court).
33. The Kansas City Southern Railway Co. v. Commissioner of Internal Revenue, 76 T.C. 1067 (US Tax Court).
Chapter 2 – Transaction/lease characterization aspects

The courts generally tend to recharacterize a transaction, styled in form of “lease”, as a “conditional sale transaction”:

- if the lease agreement confers a purchase option to the lessee as a result of which the lessee can acquire the leased asset at the end of the lease term at a price substantially lower than the expected fair market value of the leased asset;\(^{34}\)
- if the lease agreement does not provide for a purchase option or eventual transfer of title in the leased asset to the lessee, the lessor is (theoretically) entitled to remove/repossess the leased asset from the premises of the lessee, but the leased asset is tailor-made for the specific property of the lessee so that such repossession/removal would provide negligible salvage value to the lessor;\(^{35}\)
- if the lease agreement obliges the lessee to bear the entire risk of loss of or damage to the leased asset, the total rental equates with the cost of the equipment plus interest element, and the useful economic life of the equipment approximates the primary lease term;\(^{36}\)
- if the lease confers upon the lessee a purchase option, the lease rentals payable under the lease exceed the fair rental value of the asset, the lease rentals paid by the lessees are taken into account for (or have the effect of reducing) the amount of purchase option price, and the purchase option price for the leased asset is significantly below the contemplated fair market value of the leased asset at the time when the purchase option is exercisable.\(^{37}\)

2.3. Lease characterization in the United Kingdom

In the United Kingdom, characterization of a lease transaction is based on its legal form rather than the economic substance, except where a lease involves a purchase option, in which case the transaction is deemed to be a contract for hire-purchase. Accordingly, in the case of a lease not conferring a purchase option to the lessee, the characterization issue (i.e. lease v. sale) does not arise. However, since the Capital Allowances Act 2001 provides for restrictions in respect of the finance leases involving certain spe-

\(^{34}\) Walburga Oesterreich v. Commissioner of Internal Revenue, 226 F.2d 798 (US Court of Appeals Ninth Circuit).
\(^{35}\) Estate of Delano T. Starr v. Commissioner of Internal Revenue, 274 F.2d 294 (US Court of Appeals Ninth Circuit).
\(^{36}\) Mt. Mansfield Television Inc. v. United States of America, 239 F. Supp. 539 (US district court for the district of Vermont).
\(^{37}\) Transamerica Corporation v. The United States, 7 Cl. Ct. 441 (US Claims Court).
specific features (discussed at 3.5.2.6. and 3.5.2.7.), it is important to distinguish between the finance lease and the operating lease.

2.3.1. Definition of finance lease

2.3.1.1. Relevance of the Generally Accepted Accounting Principles

As per Sec. 219 of the Capital Allowances Act 2001, "finance lease" means an arrangement:
(a) which provides for plant or machinery to be leased or otherwise made available by a person ("the lessor") to another person ("the lessee"); and
(b) which, under normal accountancy practice:
   (i) falls (or would fall) to be related, in the accounts of the lessor or a person connected with the lessor, as a finance lease or a loan, or
   (ii) is comprised in an arrangement which falls (or would fall) to be so treated.

Accordingly, for tax purposes, the definition of "finance lease" is linked to the relevant Generally Accepted Accounting Principles. In the United Kingdom, lease accounting is governed by the Statement of Standard Accounting Practice 21 (SSAP 21) issued by the Institute of Chartered Accountants of England and Wales.

2.3.1.2. Definition of "finance lease" under SSAP 21

As per SSAP 21, where the substance of a lease transaction is to transfer substantially all the risks and rewards of ownership in the leased asset from the lessor to the lessee, the lease transaction is regarded as a "finance lease". For this purpose, substantially all risks and rewards are regarded as transferred if at the inception of a lease the present value of the minimum lease payments, including any initial payment, amounts to a substantial part (at least 90 per cent or more) of the fair value of the leased asset. In a finance lease, the lessor is required to treat the transaction as "sale" or "financing transaction", and record the lease payments due from the lessee as "debtor" (i.e. lease receivables).

38. SSAP 21, paragraph 15.
2.3.2. Court decision on characterization of lease transaction

In the United Kingdom, up to now, there is only one reported court decision on the issue. The case, dating back to 1913, involved the hire purchase of a railway wagon. The hirer was bound to pay a stipulated hire charge during the term of the agreement, and was not entitled to return the wagon before the end of the term under the agreement. At the end of the said term, the hirer had the option to purchase the wagon for an amount of mere one shilling. The Court of Sessions recharacterized the hire-purchase agreement as two concurrent contracts: one for the hire of the wagon and another for the sale and purchase of the wagon at a future date.

2.4. Lease characterization in Germany

2.4.1. Significance of economic ownership

In Germany, for tax purposes, characterization of a lease agreement depends upon the fact as to who is the economic owner of the leased asset. If the lessor is regarded as the economic owner of the leased asset, then the transaction is characterized as lease. However, if the lessee is the economic owner of the leased asset, then the transaction is recharacterized as sale of asset by the lessor to the lessee.

2.4.2. Definition of economic ownership

“Economic ownership” is defined in paragraph 39, subsection 2, No. 1 Abgabenordnung (AO) (German Tax Code), according to which a person other than the holder of the legal title under civil law may be treated as the economic owner of an asset when the said person has the exclusive use of the asset for its normal useful life in a way such that the holder of the legal title is excluded from using the asset.

40. Accordingly, the Court held that the total payment under the contract had to be apportioned between the hire price and the sale price for the wagon.
2.4.3. German Supreme Fiscal Court decision on transfer of economic ownership

In a landmark decision involving finance lease of movable assets, the German Supreme Fiscal Court held that, for tax purposes, lease arrangements must be qualified in accordance with the economic effects of the arrangement, i.e. on the basis of the economic ownership. The Court held that the economic ownership is transferred from the lessor to the lessee when:

- the usual economic useful life of the leased asset and the primary lease term are approximately equal; or
- the usual economic useful life of the leased asset is longer than the primary lease term, and the lessee has, at the end of the primary lease term, an option to either purchase the leased asset or to renew the lease, and the purchase price or the lease rental during the renewed lease term is considerably lower than the fair market value; or
- the leased asset is specially adapted according to special requirements of the lessee, and at the end of the lease term, practically it can be used only by the lessee.

2.4.4. Tax circulars on attribution of economic ownership

As discussed at 3.3.3.2., based on the above-mentioned decision of the German Supreme Fiscal Court, the German tax authorities issued a circular in 1971, binding on the tax authorities but not on the taxpayers and tax courts, concerning attribution of economic ownership in case of full pay-out leases. As per the said circular, the lessee is regarded the economic owner if the minimum lease term is either less than 40% or greater than 90% (with

or without a renewal option) of the ordinary useful life of the leased asset, or the lessee has the option to acquire the leased asset either below the fair market value or below the book value (in the lessor’s books). In 1975, the tax authorities issued a circular concerning the attribution of economic ownership in case of non-pay-out lease of movable properties.

2.5. Lease characterization in the Netherlands

2.5.1. Significance of economic ownership

In the Netherlands, as in Germany, characterization of a lease agreement depends on the fact as to who is the economic owner of the leased asset. If the lessor is the economic owner of the leased asset, then the transaction is regarded as lease. However, if the lessee is regarded as the economic owner, the transaction is regarded as sale.

2.5.2. Hoge Raad decision on economic ownership

As regards the issue of economic ownership, it has been held by the Hoge Raad that the legal owner (lessor) must also be regarded as the economic

---

45. For an explanation on the rationale behind the 90% and 40% limits, see Park, William W., “Tax Characterisation of International Leases: The Contours of Ownership”, Cornell Law Review November 1981, where the author states as follows: “The logic of the 90% upper limit on the lease term is obvious; relinquishment of dominion over equipment for more than nine-tenths of its life effectively eliminates the lessor’s interest in its residual value. The rationale of the 40% lower limit is perhaps less evident. ... A reasonable lessee will be unwilling to cover all costs plus interest in exchange for use of equipment for a period less than 40% of the asset’s life. According to the German view of human nature, the lessee will conclude such a deal only if it expects to acquire the property at the end of the lease term pursuant to a tacit understanding with the lessor.”

46. For a detailed reference to the said circular, see 3.3.3.3. In essence, the said circular attributes economic ownership to the party that has a right to obtain the majority of eventual capital gain in case of sale of the leased asset.

47. See Van der Laan, Robert, International Leasing, PricewaterhouseCoopers (2nd Edition), Chapter on the Netherlands, paragraph 5.3.2.


owner, unless all (and not some) economic interests/risks in the leased asset are shifted to the lessee.\(^{50}\) As per Marcel Coenen,\(^{51}\) the interests/risks could be distinguished as follows:

- the risk of the leased asset not functioning well;
- the risk of reduction in value of the leased asset in the course of time due to technical and/or economic wastage;
- the risk of loss due to external factors (such as fire, theft or destruction);
- the residual value risk.

### 2.5.3. Lease arrangement

Though there are no specific anti-avoidance provisions concerning leasing transactions, it is important to note the safe-harbour rules issued by the Dutch tax authorities by way of a “lease arrangement”.

The said lease arrangement was entered into as a result of discussions between the Dutch Ministry of Finance and the Dutch Leasing Association, and is applicable with effect from 1 January 2000. This arrangement replaced the previous arrangement effective as of 1 February 1993 (which was applicable with retrospective effect from 1 March 1988).\(^{52}\) The terms of the lease arrangement are binding on the Dutch tax authorities. The lease arrangement derives legal force by virtue of a decree issued by the State Secretary of Finance on 15 November 1999, confirming the said lease arrangement.

As per the lease arrangement, a leasing transaction is considered as “operating lease” if all of the following requirements are met:\(^{53}\)

---

52. It is also relevant to note that prior to the lease arrangement of 1 February 1993, there were two earlier arrangements with effective dates of 1 December 1984 and 1 March 1987.
Chapter 2 – Transaction/lease characterization aspects

— the lessor conducts himself as legal and beneficial owner of the leased property;\textsuperscript{54}
— the lessor has the legal title to the leased property; and
— the lessor bears positive and/or negative risk with regard to the residual value of the leased property.\textsuperscript{55}

If even one of the above-stated three requirements is not satisfied, the safe-harbour immunity under the lease arrangement will not be applicable. However, as the lease arrangement is binding only upon the Dutch tax authorities and not the taxpayers, this does not result in an automatic classification of the lease as a finance lease (i.e. treated as conditional sale for tax purposes). In such cases, the characterization of the lease as finance or as operating lease would depend on the factual situation regarding economic ownership.

\textsuperscript{54} As per a resolution (published on 20 July 2001) by the Dutch State Secretary of Finance, the lessor is regarded as conducting himself as legal and beneficial owner of the leased property if no other person can conduct as the owner of the same object. The conducting as legal and beneficial owner appears from the fact that the lessor, based on Dutch fiscal criteria, with exclusion of others, capitalizes the object on its fiscal balance sheet.

\textsuperscript{55} The lessor, in principle, bears positive and/or negative risk with regard to the residual value of the object if:

1. the purchase option price is realistic i.e., at the time of entering into the lease agreement, the purchase option price represents the estimated fair market value of the leased object at the end of the primary lease period;
2. the strike price of the purchase option is not less than 7.5% of the fiscal cost price;
3. the leased object will not be sold to the lessee at the end of the primary lease period at a purchase price below the lower of (1) and (2);
4. the fixed lease period is not longer than 85% of the estimated economic life of the leased object;
5. the residual-value risk is not covered (either in part or in full) by the lessee nor by any other party related to the lessee; the lessee therefore does not bear the risk of loss or damage (both insurable and uninsurable risks);
6. the amount of residual-value risk covered by a party not related to the lessee (if applicable) is less than 7.5% of the fiscal cost price;
7. the lessee does not actually have the economic interest in the leased object by virtue of other contracts;
8. the lease is not a so-called special lease.

Additionally, in the case of lease terms exceeding five years, the threshold of 7.5% stated in (2) and (6) is increased by 0.5% for each year by which the lease term exceeds five years.
2.6. Lease characterization in Japan

2.6.1. Lease v. sale

In Japan, a lease transaction is deemed as sale/purchase transaction if any one of the following conditions is satisfied:56

(i) during or at the end of the lease term, the leased asset is to be sold to the lessee free of charge or for a nominal compensatory amount.
(ii) during or at the end of the lease term, the lessee is granted an option to purchase the leased asset for a bargain price.
(iii) the lease is a “special lease”.
(iv) a substantial difference exists between the period of a lease contract and the statutory useful life of the leased asset.

Special lease

Lease of the following assets is considered as “special lease”:57

- assets expected to be used only by the lessee during the entire legal useful life, in view of the type, the purpose of use and the set-up of the leased asset; or
- real estate, buildings, items attached to buildings, construction equipment (except simple or temporary structures that are easily transportable and the assets that are clearly intended to be returned to the lessor at the end of the lease term); or
- assets that are manufactured to special specifications exclusively for the lessee, if use of the asset can be recognized as limited to the lessee by circumstances or location, or if the asset is used only by the lessee for substantially all of its legal useful life.

However, a “special lease” is not treated as sale/purchase transaction, if the lease term exceeds 80% of the legal useful life of the asset.

56. Paragraph 1 of JCTLE Art. 136-3 See, also Oishi, Katsuyo and others, International Leasing (2nd Edition), PricewaterhouseCoopers (Tolley LexisNexis), Chapter on Japan, paragraph 2.2.1.2.
57. See Oishi, Katsuyo and others, International Leasing (2nd Edition), PricewaterhouseCoopers (Tolley LexisNexis), Chapter on Japan, paragraph 2.2.1.2. See, also, Miyatake, Toshio, Cahiers de droit fiscal international, Volume LXXVa (Chapter for Japan, paragraph 2.2), IFA Congress 1990 (Stockholm).
Chapter 2 – Transaction/lease characterization aspects

Substantial difference between the lease term and the legal useful life

If the lease term is less than 70% (60% where the legal useful life is ten years or more) or exceeds 120% of the legal useful life of the leased property, this is regarded as a substantial difference between the lease period and the statutory useful life of the leased asset. In that case, the transaction would be deemed a sale/purchase transaction. The underlying rationale of this provision is to prevent taxpayers from significantly reducing the tax liabilities on account of substantial difference between the period of the lease term and the legal useful life of the leased asset.

Examples of transactions specifically deemed a sale/purchase

The following transactions are specifically deemed a sale/purchase:

- a contract under which the lessee has the option to renew the lease beyond the original lease term either free of charge or for a bargain lease rent (i.e. not exceeding 8.33% of the original lease rental amount);
- a defeased lease structure;
- other lease transactions designed with the purpose of significantly reducing the tax liability of the lessee or the lessor.

58. JCTLC item 12-2-2-7. See, also, Oishi, Katsuyô and others, International Leasing (2nd Edition), PricewaterhouseCoopers (Tolley LexisNexis), Chapter on Japan, paragraph 2.2.1.2.
59. JCTLC item 12-2-2-1. See, also, Oishi, Katsuyô and others, International Leasing (2nd Edition), PricewaterhouseCoopers (Tolley LexisNexis), Chapter on Japan, paragraph 2.2.1.2.
60. Typically, a defeased lease structure may involve the following:
- a defeasance bank receives advance lease rentals from the lessee, and in return it assumes the lessee’s rental payment obligations towards the lessor;
- the defeasance bank uses the said funds (i.e. advance rentals receipts) to provide a loan to the lessor to wholly or partly fund the purchase price of the leased asset.
61. E.g. a lease involving nominal lease rental payment is due in the first half of the lease term and inflated residual value at the end of the lease term, even if the difference between the span of the lease term and the legal useful life of the leased asset is not substantial.
2.6.2. Finance lease

Definition of a finance lease

The Japanese Corporate Tax Law Enforcement Circular (JCTLE Circular)\(^\text{62}\) defines a lease as finance lease if both the following conditions are satisfied:
(i) the lease contract is non-cancellable; and
(ii) the lease is a full pay-out lease.

(i) Non-cancellable contract

The first condition for a lease to constitute a finance lease is that the lease contract must be non-cancellable over the lease period. A contract is regarded as non-cancellable, if it includes conditions that are expected to effectively deter the lessee from terminating the contract. For instance, as per the Japanese Corporate Tax Law Basic Circular (JCTL Basic Circular)\(^\text{63}\), a lease contract is treated as non-cancellable if it includes the following conditions:
- a lease contract may be cancelled, but in the event of a breach or cancellation of the contract, the lessee is obliged to pay at least 90% of the total of the lease rental for the remaining part of the lease period; or
- a lease contract may be cancelled, but in that case, the lessee is obliged to pay the aggregate of the lease rental for the unexpired lease term in excess of any proceeds received by the lessor from the sale of the leased asset, unless the lessee enters into a new lease contract with the lessor for lease of an asset that is of at least the same quality level as the asset leased under the original lease contract.

(ii) Full pay-out lease

The second (cumulative) condition for the lease to constitute a finance lease is that it must be a “full pay-out” lease. The lease is regarded as “full pay-out”, if the aggregate of the lease rental payments by the lessee over the lease term covers almost all (in principle, at least 90%) of the cost of acquisition of the leased asset and other related expenses (such as related interest cost, fixed assets tax, insurance premiums etc.).

\(^{62}\) Art. 136-3, Paragraph 3. See, also, Miyatake, Toshio, *Cahiers de droit fiscal international*, Volume LXXV a (Chapter for Japan, paragraph 2.1), IFA Congress 1990 (Stockholm); and Oishi, Katsuyo, and others, *International Leasing* (2nd Edition), Price-waterhouseCoopers (Tolley LexisNexis), Chapter on Japan, paragraph 2.2.1.1.

\(^{63}\) Item 12-2-1-1.
As per the JCTL Basic Circular,\textsuperscript{64} for ascertaining as to whether the lease rental payments cover “almost all” of the aggregate of the cost of acquisition and related expenses, the following amounts should be added to the amount of lease rentals:

- the “option exercise price”: where the lessee has an option to purchase the leased asset at a future date and, at the inception of the lease, the lessee exercising such option appears reasonably certain, the exercise price of the option when exercised should be added to the total amount of the lease rental;

- where, upon cancellation of the lease contract, the lessee is obliged to pay the aggregate of the lease rental for the unexpired lease term in excess of any proceeds received by the lessor from the sale of the leased asset, the amount of the sale proceeds should be added to the aggregate amount of the lease rentals.

\textsuperscript{64} Item 12-2-1-3.