International taxation of cross-border leasing income
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CHAPTER 3

DEPRECIATION/CAPITAL ALLOWANCES ASPECTS

3.1. Introduction

Normally, tax depreciation in respect of a leased asset constitutes one of the most substantial items of deduction in computation of a lessor’s taxable income (in the residence state) from a lease transaction. Often, during the early years of a lease term, the allowable tax depreciation would exceed the gross lease rental income, that would generate a tax loss (but not the actual financial loss) for the lessor. The tax loss provides advantage to the lessor on two counts: (1) the lessor’s tax liability in respect of the leasing income is postponed to a later year (i.e. deferred tax liability), and (2) the lessor or a group company may be able to set off the tax loss against other taxable income. On account of the “time value of money”, the deferred tax liability has a quantifiable value, a substantial part of which the lessor passes on to the lessee in the form of a reduction of lease rentals.

Also, often, the tax-exempt entities, governments as well as local authorities that cannot avail of the tax depreciation due to their tax-exempt status find it advantageous to enter into lease transactions (instead of acquiring assets outright or through loan funding), as the lessor may be in a position to utilize the tax depreciation – a part of which is effectively passed on to the lessee in the form of the reduced lease rentals. Even for that reason, the tax depreciation is one of the central issues in leasing.

In cross-border leasing, it may be possible for lessors and lessees to obtain even greater benefits (as compared to domestic leasing transactions) by exploiting the differences in the tax depreciation rules under tax laws of various countries. Such differences may be classified into the following four categories, as differences on account of:

65. See, for instance, “Metro de Lisboa: Engine of Change”, Asset Finance International April 2003, wherein the Finance Director of the operator of Lisbon’s local rail network explains that although the capital market is one possibility where the operator could obtain funds for its investment plans, in terms of pricing, leasing transactions are more attractive because of the fiscal component to the leases.

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(i) the general scheme of depreciation allowances, including the permissible methods for depreciating assets and depreciation rates/recovery periods;
(ii) eligibility criteria for entitlement to depreciation (legal ownership v. economic ownership);
(iii) specific incentives (e.g. accelerated depreciation); and
(iv) restrictions in respect of certain assets (e.g. leasing of assets to the tax-exempt entities).

It is relevant to note that a lessor that is able to obtain a greater amount of tax advantage would have a competitive edge over other lessors that are not able to obtain the same amount of tax advantage. Therefore, it is crucial to analyse the differences in the tax depreciation systems in few select jurisdictions. Sections 3.2. to 3.5. of this chapter deal with the said differences under the tax laws of the United States, the United Kingdom, Germany, the Netherlands and Japan.

3.2. General scheme of depreciation allowance

3.2.1. United States

In the United States, Sec. 167 of the Internal Revenue Code (IRC) provides for depreciation deduction in respect of personal property, whereas Sec. 168 stipulates:

- applicable methods of depreciation;
- applicable recovery period; and
- applicable convention.

67. The tax advantage to the lessor may arise on account of multiple factors such as, inter alia, higher depreciation due to more favourable depreciation methods, higher rates of depreciation including incentives such as free depreciation, overall effective tax rate for the lessor or the group as a whole, etc.
68. The IRC uses the term “personal property” for movable assets.
69. For more elaborate description of the depreciation system under the IRC, see Abrams, Howard E. and Doernberg, Richard L., Essentials of United States taxation, pp. 1-30, 1-33.
3.2.1.1. Generally applicable method of depreciation

For most personal property, the applicable method is the “double declining-balance method”. Alternatively, this method is also known as the Modified Accelerated Cost Recovery System (hereinafter “MACRS”).

Under the MACRS, the starting point is the determination of the percentage of the property’s adjusted basis that would be depreciable under the straight-line method, and then the said percentage is simply doubled (therefore, the method is also known as double declining-balance method). For instance, a property with useful economic life of five years would qualify for 20% depreciation per annum under the straight-line method; the same property would be subject to depreciation at the rate of 40% per annum, on a declining-balance basis, under the MACRS.

Typically, as compared to the straight-line method, the declining-balance method would afford greater amounts of depreciation in the initial years of the asset, and smaller amounts of depreciation in the later years of the property. However, as an interesting feature of the MACRS, at the point when the double declining-balance method would produce a depreciation deduction less than the depreciation deduction under the straight-line method, the taxpayer is permitted to switch over to the straight-line method. However, the aggregate of the depreciation deductions in respect of a property cannot exceed its cost.

For the purpose of depreciation deduction, salvage value of the property is not taken into account.

3.2.1.2. Applicable recovery period

Sec. 168(c) IRC stipulates “applicable recovery periods” for various types of property. For instance, office equipment and machinery are generally depreciable over a seven-year period, whereas non-residential real property, such as an office building or a factory, is generally depreciable over a 39-year period.

3.2.1.3. Applicable convention

As such, a property is generally depreciable once it is placed in service. However, in view of the perceived taxpayer and administrative difficulties
as to the determination of the exact time when the property is placed in service, for the first year when a personal property is placed in service, it is deemed as if it was placed in service half way through the year. This is referred to as the “half-year convention”. Under this convention, in the first year in which a personal property is placed in service, the taxpayer is entitled to half of the depreciation deduction that would have been normally allowable to him under the double declining-balance method. This is irrespective of whether the property was placed in service on the first day or the last day of the year.

To counter abusive practices, however, the Internal Revenue Code also contains a “mid-quarter” convention, as per which, if the total basis of the personal property placed in service during the last quarter of the year exceeds 40% of the total basis of all property placed in service during the year, the depreciation in respect of all property placed in service during the year would be determined more precisely.

In the case of real property, depreciation for the year in which the property is first placed in service is determined using the “mid-month convention”.

3.2.2. United Kingdom

3.2.2.1. General

In the United Kingdom, the depreciation allowance is referred to as “capital allowance”. The scheme of capital allowances is governed by the Capital Allowances Act 2001.

The capital expenditure qualifying for capital allowances is required to be pooled together for the purposes of capital allowances (also referred to as writing down allowances), balancing charge and balancing allowance. Ordinarily, most items of plant and machinery are subject to capital allowances at the rate of 25% on the written-down value basis (declining-balance method). Long-life assets (i.e. assets with a useful economic life exceeding 25 years) are subject to capital allowances at the rate of 6%. Subject to certain exceptions, a taxpayer may elect to remove short-life assets (i.e. assets
with an expected useful life of less than four years) from the general plant and machinery pool and hold them in a single-asset pool.\textsuperscript{70}

The Capital Allowances Act also provides for a “first-year allowance” in addition to the normal writing-down allowances in respect of the following assets:

<table>
<thead>
<tr>
<th>Nature of qualifying expenditure</th>
<th>First-year allowance (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>expenditure incurred before 11 May 2002 by a small or medium-sized enterprise on the provision of plant or machinery for use primarily in Northern Ireland\textsuperscript{a}</td>
<td>100</td>
</tr>
<tr>
<td>expenditure incurred by a small or medium-sized enterprise\textsuperscript{b}</td>
<td>40</td>
</tr>
<tr>
<td>expenditure incurred by a small enterprise before 31 March 2003 on information and communications technology\textsuperscript{c}</td>
<td>100</td>
</tr>
</tbody>
</table>

\textsuperscript{a} Sec. 44 of the Capital Allowances Act 2001, subject to exclusions specified in Sec. 46.
\textsuperscript{b} Sec. 45 of the Capital Allowances Act 2001, subject to exclusions specified in Sec. 46.
\textsuperscript{c} General exclusion 6, Sec. 46(2), Capital Allowances Act 2001.

It is relevant to note that expenditure on the provision of plant or machinery for leasing does not qualify for the first-year allowance.\textsuperscript{71}

3.2.2.2. Capital allowances for cars

First-year allowances are not available in respect of cars. Cars costing less than GBP 12,000 form part of the main pool subject to capital allowances at the rate of 25%. Subject to some exceptions, cars costing more than GBP 25,000 qualify for capital allowances at the rate of 25%, subject to a maximum of GBP 3,000 per car per annum.

\textsuperscript{70} For a detailed description of the UK capital allowances system, see Davis, C. and others, \textit{Handbook on the Capital Allowances Act 2001} (Butterworths Tolley).
\textsuperscript{71} Sec. 40 of the Capital Allowances Act 2001, subject to certain exclusions (specified in Sections 41, 42 and 46).
3.2.3. Germany

For tax depreciation purposes, the straight-line method, the declining-balance method and the production method are recognized. In certain cases, some other specific methods (e.g. output method, depletion method) may be acceptable. However, the depreciation methods based on gross profit, the replacement cost of assets and the lump-sum writing-off of a business are specifically prohibited. A change in the method is allowed only from the declining-balance method to the straight-line method. A change in the other direction is not permitted.

For movable fixed assets purchased during the first half of the financial year, depreciation for the full financial year is permissible. Movable fixed assets purchased during the second half of the financial year are subject to depreciation at 50% of the annual depreciation rate. The declining-balance rate is restricted to three times the allowable straight-line rate, with a maximum of 30%.

The rates for movable fixed assets are set out in the official recommended tables (AfA-Tabellen) published by the Federal Ministry of Finance. With effect from 1 January 2001, the following straight-line rates are applicable:

- 6% to 10% for machinery;
- 12.5% for office equipment;
- 8% to 10% for office furniture;
- 33.3% for computers; and
- 11% to 16% for cars, trucks, etc.

3.2.4. Netherlands

The straight-line method is the most commonly used depreciation method. However, where appropriate, other methods such as the declining-balance, the unit-of-production or the percentage depletion methods may be used.

72. For a detailed description of the depreciation rules under the German tax law, see International Bureau of Fiscal Documentation, 'Guides to European Taxation, European Taxation Database'.

73. For example, in the case of assets which provide for a greater utility in the early years of their useful economic life as compared to the subsequent years, the use of the declining-balance method is considered appropriate. In the case of mines, use of depletion method is considered appropriate.
Eligibility for depreciation allowance (ownership criterion)

The tax law or regulations do not prescribe depreciation rates. Cost of the asset, less the estimated residual value is depreciated over the useful economic life of the asset. Assets (e.g. land) that are normally not subject to reduction in value are not depreciable.\textsuperscript{74}

3.2.5. Japan

A taxpayer may use either the straight-line method or the declining-balance method for deprecating tangible assets.\textsuperscript{75} Certain fixed assets used for mining purposes may be depreciated using the production method, and certain items of assets (such as rail and electric poles) subject to frequent replacement may be depreciated using the replacement method. Other depreciation methods may be used only with the approval of the Director of the District Tax Office.

Under the straight-line method of depreciation, 90% of the cost of acquisition of the asset is evenly depreciated over the useful life of the asset. The Ministry of Finance provides a table for “legal useful life” of various categories of assets.

Under the declining-balance method of depreciation, a fixed rate (determined on the basis of the tax tables) is used for computing the maximum depreciable amount for each year.\textsuperscript{76}

3.3. Eligibility for depreciation allowance (ownership criterion)

As finance lease transactions are generally based on the lessors’ ability to obtain tax depreciation, it is likely that if the lessor was not eligible for depreciation allowance, then the lessee would have been less inclined to enter into a lease transaction (as the amount of lease rentals would have increased). Accordingly, it is submitted that eligibility for depreciation allow-

\textsuperscript{74} For a detailed description of the depreciation rules under the Dutch tax law, see International Bureau of Fiscal Documentation, \textit{Guides to European Taxation, European Taxation Database}.

\textsuperscript{75} However, for intangible assets, only the straight-line method is permissible.

\textsuperscript{76} For a detailed description of the depreciation rules under Japanese tax law, see International Bureau of Fiscal Documentation, \textit{Taxes and Investments in Asia and the Pacific, Asia Pacific Taxation Database}.

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ance is one of the central issues in tax-driven leasing, including cross-border leasing. Indeed, in the cross-border double-dip leases, eligibility for depreciation allowance is the most fundamental issue.

3.3.1. United States

In the United States, eligibility for tax depreciation in respect of a leased asset depends on the economic ownership rather than the legal ownership of the leased asset. According to Amaro, the characterization of a transaction is crucial for eligibility for depreciation allowance in respect of a leased asset. If the transaction is regarded as a “lease”, then the lessor is entitled to tax depreciation in respect of the leased asset. Conversely, if the transaction is regarded as a “sale”, then the lessee is entitled to tax depreciation on the leased asset. The characterization issues, including the judicial developments and IRS rulings, are analyzed in detail at 4.2.

3.3.2. United Kingdom

In the United Kingdom, entitlement to capital allowances is based on the legal ownership rather than the economic ownership. Accordingly, the lessor and not the lessee is entitled to capital allowances. As the economic substance is irrelevant for entitlement to capital allowance in respect of a leased asset, subject to certain exceptions, a lessor is entitled to capital allowance irrespective of the nature of the lease being financial or operational. As compared to tax laws of other jurisdictions, this could be regarded as a distinct feature of the UK tax system. However, it is relevant to note that if the lease confers an option to the lessee for acquiring the leased asset in future, then the transaction is treated as a contract for hire-purchase. In that case, the lessee (and not the lessor) would be entitled to capital allowances on the leased asset, subject to satisfaction of certain other conditions.

3.3.3. Germany

3.3.3.1. Economic ownership

For tax (as well as for accounting) purposes, the economic owner rather than the legal owner of the asset is entitled to depreciation.⁸⁰

In general, the economic owner of an asset is the person enjoying an unrestricted right to dispose of the asset. Also, as a general rule, the person bearing the risk of asset in respect of damage to the asset, repairs, etc. is regarded as its economic owner.

"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 if (i) the said person has the exclusive use of the asset for its normal useful life, and (ii) the holder of the legal title is excluded from using the asset.⁸¹

In a landmark decision⁸² concerning finance lease of movable assets, the German Supreme Fiscal Court held that, for tax purposes, a lease transaction must be qualified in accordance with the economic effects of the arrangement, i.e. on the basis of the economic ownership.⁸³ The Court held that the economic ownership is regarded as 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

⁸² Dated 26 January 1970.
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-- the leased asset is specially adapted according to the specific requirements of the lessee, so that the asset is suitable only for the use by the lessee.

3.3.3.2. Circulars issued by the Federal Ministry of Finance

Based on the above-mentioned decision of the German Supreme Fiscal Court, the German tax authorities issued a circular in 1971,\(^{84}\) binding on the tax authorities but not on the taxpayers and tax courts, concerning attribution of economic ownership in the case of full pay-out leases of movable assets and another circular,\(^{85}\) dated 21 March 1972, dealing with the finance lease of immovable assets. In 1975, the tax authorities issued a circular concerning attribution of economic ownership in the case of non-full pay-out lease of movable properties.\(^{86}\)

The Federal Ministry of Finance distinguishes between the full pay-out leasing and the non-full pay-out leasing. The circular dated 19 April 1971 dealing with full pay-out leasing is supplemented by a circular dated 22 December 1975 concerning non-full pay-out leasing.\(^{87}\)

3.3.3.2.1. Full pay-out v. non-full pay-out leasing

A lease is considered as full pay-out if during the minimum lease term (amounting to between 40% and 90% of the ordinary useful life of the leased asset) the lessor recoups from the lessee at least the acquisition or manufacturing costs and all other relevant additional costs, including the lessor’s financing costs. Conversely, a lease is regarded as non-full pay-out if the fixed lease term ranges from 40% to 90% of the ordinary useful life of the leased asset, but the lessor only partially recovers the acquisition/manufacturing costs. In other words, in a non-full pay-out lease, the lessor

85.  BStBl I 1972, p. 188. As this study does not focus on the subject of leasing of immovable assets, this circular is not examined in detail.
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depends on realization/sale value of the leased asset for recovering his investment in the leased asset.

3.3.3.2.2. Attribution of economic ownership in the case of full pay-out leasing

According to the circular dated 19 April 1971, the lessor is regarded as the economic owner of the leased asset if the following conditions are satisfied:
- the minimum lease term is between 40% and 90% of the ordinary useful life of the leased asset, and the lessee has neither an option to acquire the leased asset during/after the lease term, nor an option to renew the lease term; or
- the minimum lease term is between 40% and 90% of the ordinary useful life of the leased asset, the lessee does not have the option to renew the lease term, but has the option to acquire the leased asset at the end of the lease term provided the acquisition price is not below the fair market value (at the time of the sale) or the book value of the leased asset.

Conversely, as per the circular, the economic ownership of the leased asset in a full pay-out lease is attributable to the lessee instead of the lessor if:
- the minimum lease term is either below 40% or above 90% of the ordinary useful life of the leased asset;
- the lessee has the option to renew the lease (so that the lease term may extend beyond 90% 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 (as per books of account of the lessor).

3.3.3.3. Attribution of the economic ownership in the case of non-full pay-out leasing

The Federal Finance Ministry’s circular dated 22 December 1975 deals with economic ownership of the leased asset in the case of three types of lease contracts.

Type 1: Lessor has a “put option”

In this type of lease contract, the lessor has a “put option” such that he can require the lessee to purchase the leased asset at the end of the lease term,
for a predetermined price. However, the lessee does not have a call option to acquire the leased asset at the end of the lease term.

In this situation, at the end of the lease term, if the fair market value of the leased asset is above the predetermined acquisition price, then the lessor would not exercise his put option. However, if the fair market value of the leased asset drops below the predetermined acquisition price, then the lessor would exercise the put option. Thus, potentially, the lessor may gain from the increase in the leased asset’s expected fair market value (which can be expected to be identical to the predetermined acquisition price, at the inception of the lease). Therefore, as per the circular, the lessor is regarded as the economic owner of the leased asset in this situation. Accordingly, in this situation, the lessor would be entitled to depreciation on the leased asset.

**Type 2: Lessor and lessee share proceeds from the sale of leased asset**

In this type of lease arrangement, at the end of the lease term, the lessor sells the leased asset. If the sale proceeds are less than the lessor’s unrecovered costs, the lessee would pay to the lessor the difference between the unrecovered costs and the amount of sale proceeds. In this case, the lessor is regarded as the economic owner of the leased asset.

If the sale proceeds exceed the lessor’s unrecovered cost, the lessor would retain at least 25% of the amount of sale proceeds in excess of unrecovered costs. In other words, the lessor would pass on to the lessee not more than 75% of the amount of sale proceeds in excess the lessor’s unrecovered costs. In that case, the lessor will be regarded as the economic owner of the leased asset. If, however, the lessor passes on to the lessee more than 75% of the amount of sale proceeds in excess of the unrecovered costs, then the lessee is regarded as the economic owner.

**Type 3: Lessee has the option to cancel the contract**

Under this type of lease arrangement, the lessee has the option to cancel the lease contract at any time after 40% of the ordinary useful life of the leased asset. Upon the lessee exercising such option, the lessor would sell the asset. The lessee is obliged to compensate the lessor for the lessor’s unrecovered costs (which are not covered by the lease rental payments prior to the sale of the leased asset). Ninety percent of the sale proceeds would be offset against the lessee’s obligation to compensate the lessor. In other words, the lessee would be required to pay to the lessor the difference between the un-
Eligibility for depreciation allowance (ownership criterion)

recovered costs and 90% of the sale proceeds. However, if 90% of the sale proceeds exceed the unrecovered costs, then the lessor will not share any part of such excess with the lessee. Thus, in this case, the lessor is more than a mere legal owner, as he enjoys the economic rewards arising from any increase in the market value of the leased asset. In such a case, the lessor is regarded as the economic owner of the leased asset.

3.3.4. Netherlands

Under the Dutch tax law, the economic owner (and not the legal owner) of the asset is entitled to depreciation.

As regards the issue of economic ownership, it is relevant to note a decision of the Hoge Raad,88 wherein it was held that the legal owner (lessor) is also regarded as economic owner, except all (and not some) economic interests/risks in the leased asset are shifted to the lessee. As per Marcel Coenen,89 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 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.

It is also relevant to note the lease arrangement,90 as per which the lessor is regarded as the economic owner of the leased asset if:

a) the lessor conducts himself as legal and beneficial owner of the leased asset;
b) the lessor has the legal title to the leased property; and
c) the lessor bears positive and/or negative risk with regard to the residual value of the leased property.

90. See discussion at 2.5.3.
3.3.5. Japan

In Japan, in the case of the operating as well as the finance lease (not deemed a sale/purchase transaction), the lessor is entitled to depreciation on the leased asset. In the case of a lease that is deemed a sale/purchase transaction, the lessee is entitled to tax depreciation.\(^\text{92}\)

3.4. Accelerated depreciation/capital allowances

3.4.1. United States

Other than the Modified Accelerated Cost Recovery System discussed earlier, the IRC does not provide for accelerated depreciation that is relevant for the purpose of this study.

3.4.2. United Kingdom

3.4.2.1. First-year allowances

For 12 years prior to 1984, the first-year allowances were granted for up to 100\% of the capital expenditure. Between 1984 and 1986, the first-year allowances were available at 60\% of the capital expenditure. However, for capital expenditure incurred subsequent to 31 March 1986, the first-year allowances were abolished.\(^\text{93}\) Later on, they were reintroduced on a temporary basis. The Finance Act 2000 made the reintroduction of the first-year allowances permanent for expenditure incurred by small and medium-sized enterprises on or after 2 July 1998.

At present, the first-year allowances are available in respect of the following qualifying expenditure:\(^\text{94}\)

\(^{92}\) See Oishi, Katsuyo and others, \textit{International Leasing} (2nd Edition), PricewaterhouseCoopers (Tolley LexisNexis), Japan Chapter, paragraph 2.2.3.1.


\(^{94}\) See International Bureau of Fiscal Documentation, \textit{Guides to European Taxation, European Taxation Database}. 
Accelerated depreciation/capital allowances

- expenditure incurred after 1 July 1998 by a “small or medium-sized enterprise”⁹⁵ (allowance at 40% of the expenditure);
- expenditure on “information and communications technology”⁹⁶ incurred between 1 April 2000 and 31 March 2003 by a “small enterprise”⁹⁷ (allowance at 100% of the expenditure);
- expenditure on “energy-saving plant or machinery”⁹⁸ meeting certain specified criteria, incurred on or after 1 April 2001⁹⁹ (allowance at 100% of the expenditure);
- expenditure incurred after 31 March 2003 on water-efficient technology assets;
- expenditure on industrial buildings in qualifying enterprise zones at a rate of 100%.

3.4.2.2. Capital allowances for ships

Ships are subject to special rules under the Capital Allowances Act 2001. Key features of the said special rules are as follows:¹⁰⁰

The term “ship” is not defined in the Capital Allowances Act, 2001. However, the term “ship” is defined in the Merchant Shipping Act 1984 as in-  

⁹⁵ For this purpose, “small or medium-sized enterprises” mean the enterprises meeting at least two of the following three conditions:
- turnover not exceeding GBP 11.2 million in the relevant financial year;
- assets not exceeding GBP 5.6 million;
- number of employees not exceeding 250.

⁹⁶ For this purpose, “expenditure on information and communications technology” means expenditure on the following:
- computers and associated equipment, including peripheral devices for computers, equipment for data connection between computers or between a computer and a data communication network, and dedicated electrical systems for computers;
- other qualifying equipment, including wireless application protocol telephones, third-generation mobile telephones, devices designed to be used for receiving and transmitting information from and to data networks; and
- software.

⁹⁷ For this purpose, a “small enterprise” means an enterprise meeting at least two of the following three conditions:
- turnover not exceeding GBP 2.8 million;
- assets not exceeding GBP 1.4 million;
- number of employees not exceeding 50.

⁹⁸ Such plant or machinery must be unused, and not second-hand.

⁹⁹ For income tax purposes, the accounting period ending after 5 April 2001.

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including every description of vessel used in navigation not propelled by oars.\textsuperscript{101}

Expenditure on acquisition of a ship is allocated to a single-asset pool, unless:
- the taxpayer elects not to allocate the expenditure to the single-asset pool;
- the ship is acquired for the purpose of special leasing; or
- the ship is otherwise provided for leasing or letting on charter other than for “overseas leasing” or “protected leasing”.

Sec. 130 of the Capital Allowances Act 2001 provides for free depreciation in respect of ships, i.e. capital/writing-down allowances on a ship are permitted to be postponed to any later period, as long as the owner of the ship continues the business for which the ship was acquired. Thus, this provision enables a shipping company to defer and stockpile the writing-down allowances until it can effectively use it to set off against taxable income in a future year.

3.4.2.3. Rollover relief in respect of disposal of ships

Under the general scheme of capital gains taxation, the excess of consideration for disposal of a capital asset over the written-down value of the asset at the time of its disposal is treated as balancing charge (taxable as capital gains). However, in respect of ships, the balancing charge may be deferred, provided the taxpayer acquires a new ship. It is not necessary, however, for the taxpayer company itself to acquire a new ship, and it suffices if any other group company acquires the new ship.

The deferral works by treating an amount equal to the part of the balancing charge in the general pool that arises from the disposal of the old ship as qualifying expenditure. This cancels the balancing charge where it arises, and when a new ship against whose costs the balancing charge is rolled over is acquired, the same amount is treated as a disposal value in the single ship pool for that ship. This reduces the expenditure qualifying for allowances

in the single ship pool for the new ship, so that the balancing charge is collected over time by way of a reduction of the allowances given on the new ship.\textsuperscript{102}

3.4.3. Germany

In addition to the regular depreciation, in certain cases, accelerated depreciation is available under German tax law. For the purposes of accelerated depreciation, only the straight-line method and the output methods of depreciation are allowed; use of the declining-balance method is not permissible.\textsuperscript{103}

Accelerated depreciation is available in the following cases:\textsuperscript{104}

- accelerated depreciation of the cost of movable fixed assets is allowed if the net assets of the business do not exceed EUR 204,517.\textsuperscript{105} In such cases, the rate of accelerated depreciation is 20\% and may be claimed during the first five years in addition to the regular depreciation. As an exception to the general rule, the accelerated depreciation can also be combined with the declining-balance method;

- private hospitals may claim depreciation of 50\% on movable fixed assets and 30\% on immovable fixed assets during the first five years after acquisition;\textsuperscript{106}

- the renovation and maintenance costs of buildings located in the areas declared development areas, and the buildings declared monuments, may be depreciated at a rate of up to 10\% per year over ten years;\textsuperscript{107}

- accelerated depreciation of 40\% in the first five years was available for acquiring ships registered in Germany provided the acquisition was based on a contract concluded before 25 April 1996 and the ship was actually acquired or manufactured before 1 January 1999.\textsuperscript{108} The ship could not be sold for eight years. Under the same conditions, acceler-

\textsuperscript{102} For a detailed description of the rollover relief, see Sherry, Michael, and Rippon, Louise, \textit{Whiteman on Income Tax} (14th Cumulative supplement to the 3rd edition) (Thomson Sweet & Maxwell), Chapter A1.

\textsuperscript{103} See International Bureau of Fiscal Documentation, \textit{Guides to European Taxation, European Taxation Database} (German Chapter, paragraph 2.13.1.).

\textsuperscript{104} See International Bureau of Fiscal Documentation, \textit{Guides to European Taxation, European Taxation Database} (German Chapter, paragraph 2.13.1.).

\textsuperscript{105} Sec. 7g EStG.

\textsuperscript{106} Sec. 7f EStG.

\textsuperscript{107} Sec. 7h and 7i EStG.

\textsuperscript{108} Sec. 82f EStDV.
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...ated depreciation at 30% was available for aircraft used in international transport.\textsuperscript{109} The aircraft could not be sold for six years.

3.4.4. Netherlands

In the Netherlands, the following four classes of assets are eligible for “free depreciation” in the year of acquisition/production to the extent of the cost of acquisition/production:\textsuperscript{110}

- assets that are important for protection of the environment in the Netherlands;
- assets that are important for improvement of the working conditions;
- assets that are of a high-grade technological status or are used for research and development; and
- assets used for production in certain regions or certain groups of companies designated by the government.

In respect of the ships operated mainly from the Netherlands, depreciation is allowed at the rate of 20% per annum (on cost of the ship minus residual value).\textsuperscript{111}

3.4.5. Japan

Buildings and certain items of machinery, plant and equipment fulfilling certain conditions qualify for special depreciation and accelerated depreciation.\textsuperscript{112}

\textsuperscript{109} Sec. 82f ESTDV.
\textsuperscript{110} See International Bureau of Fiscal Documentation, \textit{Guides to European Taxation, European Taxation Database} (the Dutch Chapter, paragraph 2.13.1.).
\textsuperscript{111} See International Bureau of Fiscal Documentation, \textit{Guides to European Taxation, European Taxation Database} (German Chapter, paragraph 2.13.1.).
\textsuperscript{112} See Appendix 2.
3.5. Restrictions on depreciation/capital allowances in case of leasing

3.5.1. United States

3.5.1.1. Alternative Depreciation System (ADS)

In the early 1980s, several tax-exempt entities, such as non-profit organizations, and even governments (federal, state and local) used leasing arrangements to leverage on their unusable depreciation deductions, by effectively transferring (for a price) such depreciation benefit to private parties. For instance, the cities of Atlanta and Austin entered into sale-and-leaseback transactions in respect of their city halls, so that the buyer/lessor could claim tax depreciation on the said city halls and pass a substantial part of that benefit back to the lessee (the two cities) by way of lease rentals below the normal market rates. Likewise, even the US Navy sold several ships to corporations, so as to enable the corporations to claim depreciation and lease back the ships to the Navy.\(^\text{113}\)

With a view to counter such “depreciation transfer schemes”, IRC Sec. 168 was amended, and assets used predominantly outside the United States and any “tax-exempt use property” are subjected to the ADS. For this purpose, the term “tax-exempt use property” means the portion of any property leased to a “tax-exempt entity”.\(^\text{114}\) A “tax-exempt entity” includes a foreign lessee of an asset owned by a US entity.\(^\text{115}\) In such cases, the system of depreciation allowance is modified (and hence the name “ADS”) in the following manner:\(^\text{116}\)

- MACRS is replaced with the straight-line method; and
- the recovery period over which the depreciation would be granted under the ADS is increased in the case of certain assets, so that the amount of depreciation allowance in a given year is reduced. The following table highlights the point:

\[^{113}\text{See Park, E. John, “Cross-border Equipment Leasing: Recent Developments Related to Section 168(G)”, Virginia Tax Review Fall, 1996.}\]
\[^{114}\text{Sec. 168(h)(1)(A).}\]
\[^{115}\text{Sec. 168(h)(2)(A)(iii).}\]
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<table>
<thead>
<tr>
<th>Type of asset</th>
<th>Normal recovery period under MACRS</th>
<th>Extended recovery period under ADS</th>
</tr>
</thead>
<tbody>
<tr>
<td>qualified rent-to-own consumer assets</td>
<td>3 years</td>
<td>4 years</td>
</tr>
<tr>
<td>computer-based telephone central office switching equipment</td>
<td>5 years</td>
<td>9.5 years</td>
</tr>
<tr>
<td>railroad track</td>
<td>7 years</td>
<td>10 years</td>
</tr>
<tr>
<td>municipal wastewater treatment plant</td>
<td>15 years</td>
<td>24 years</td>
</tr>
<tr>
<td>telephone distribution plant/ equipment used for 2-way voice and data exchange</td>
<td>15 years</td>
<td>24 years</td>
</tr>
</tbody>
</table>

Further, in any case, the extended recovery period would not be less than 125% of the lease term, so that the effective recovery period would be (i) the normal recovery period under MACRS, (ii) the extended recovery period under ADS, or (iii) 125% of the lease term, whichever is longer.

Thus, the reduced straight-line rate of depreciation substantially dilutes the tax advantages of cross-border (out-bound) leasing.

3.5.1.2. Exceptions

3.5.1.2.1. Qualified technological equipment (QTE)

(a) Relief in respect of cross-border (outbound) QTE leasing

IRC Sec. 168(g)(3)(C) provides for a significant exception, which dilutes the deterring effects of the ADS. As per the said section, for purposes of the ADS, the recovery period in respect of QTE would be five years, so that QTE is depreciated over the five-year period on a straight-line basis. In absence of this relief, QTE subject to an outbound lease would have been depreciable over a much longer period.

(b) Relief in respect of domestic QTE leasing

It is also relevant to note that Sec. 168(h)(3)(A) excludes from the definition of “tax-exempt use property” QTE if the lease to the tax-exempt entity has a lease term not exceeding five years. Accordingly, QTE leased to a tax-

117. For practical aspects concerning leasing of QTEs, see “QTEs: Past, Present, and Future”, *Asset Finance International* November 2002.
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exempt lessee, for use within the United States (domestic lease) for a term not exceeding five years is not covered by ADS. Such QTE would qualify for accelerated depreciation under the MACRS. However, as the said provision excludes the QTE only from the definition of “tax-exempt use property”, this relief does not extend to a cross-border (outbound) lease. Accordingly, QTE under an outbound lease would be subject to ADS (hence depreciable by the straight-line method instead of double declining-balance method). Therefore, QTE that is the subject matter of a domestic lease qualifies for a more favourable tax depreciation treatment as compared to QTE that is the subject matter of a cross-border (outbound) lease, although a shorter (five-year) recovery period in case of an outbound QTE lease still provides a significant concession as compared to outbound lease of non-QTE assets.

(c) **Meaning of QTE**

Sec. 168(i)(2)(A) defines QTE to mean:

- any computer or peripheral equipment;\(^ {118}\)
- any high-technology telephone station equipment installed on the customer’s premises; and
- any high-technology medical equipment.\(^ {119}\)

(d) **Influence of QTE relief on US outbound leasing in practice**

The above-mentioned QTE exception has had substantial positive influence on the US outbound cross-border leasing of high-technology assets. Since 1995, the assets leased on the basis of the QTE provisions include:

\(^{118}\) For this purpose, Sec. 168(i)(2)(B)(i) defines a computer to mean a programmable electronically activated device which (i) is capable of accepting information, applying prescribed processes to the information, and supplying the results of these processes with or without human intervention, and (ii) consists of a central processing unit containing extensive storage, logic, arithmetic and control capabilities. Sec. 168(i)(2)(B)(iii) defines a “related peripheral equipment” to mean any auxiliary machine (whether online or offline) which is designed to be placed under the control of the central processing unit of a computer. However, as per Sec. 168(i)(2)(B)(iv), the term “computer or peripheral equipment” does not include (i) any equipment which is an integral part of other property which is not a computer, (ii) typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, and (iii) equipment of a kind used primarily for amusement or entertainment of the user.

\(^{119}\) Sec. 168(i)(2)(C) defines “high-technology medical equipment” to mean any electronic, electromechanical, or computer-based high-technology equipment used in the screening, monitoring, observation, diagnosis, or treatment of patients in a laboratory, medical, or hospital environment.
telecommunication equipment and telecommunication systems;¹²⁰
flight simulators and rail signalling systems;¹²¹
postal sorting equipment and air traffic control systems;¹²² and
Automatic Train Protection Systems (ATPs), Automated Revenue Collection Systems (ARCs), passenger baggage handling systems at airports, and cargo and catering management systems.¹²³

3.5.1.2.2. Other exceptions

Sec. 168(g)(4) excludes, inter alia, the following tangible assets (used predominantly outside the United States) from applicability of the ADS:

- any aircraft which is registered by the Administrator of the Federal Aviation Agency and which is operated to and from the United States or is operated under contract with the United States;
- any communication satellite,¹²⁴ or any interest therein, of a US person;
- any property (other than a vessel or an aircraft) of a US person that is used in international or territorial waters within the northern portion of the western hemisphere for the purposes of exploring for, developing, removing, or transporting resources from ocean waters or deposits under such waters.

3.5.2. United Kingdom

Though, as such, a lessor in a finance lease is entitled to capital allowances in respect of the leased assets, the following restrictions may substantially affect his entitlement:

3.5.2.1. Denial of the first-year allowance

As noted earlier, expenditure on the provision of plant or machinery for leasing does not qualify for the first-year allowance.¹²⁵

¹²⁴ As defined in Sec. 103(3) of the Communications Satellite Act of 1962.
¹²⁵ General exclusion 6, Sec. 46(2), Capital Allowances Act 2001.
3.5.2.2. Restriction in the case of a purchase option

If the lease confers the option to the lessee to acquire the leased asset in future, then the transaction would be deemed a contract for hire-purchase. In that case, the lessee (and not the lessor) would be entitled to the capital allowances on the leased asset.\(^{126}\) This may neutralize the tax advantage of leasing, which is often the prime reason for preference towards leasing as compared to the other forms of asset financing. Accordingly, it is discernible that tax-driven leasing arrangements in the United Kingdom would not provide options to the lessees for acquiring the leased assets.

3.5.2.3. Restriction on capital allowances in the year of acquisition

In the case of a finance lease, for capital allowances purposes, the qualifying expenditure for the year of acquisition of the asset is allowable only pro rata, corresponding to the period for which the finance lessor owned the asset.\(^ {127}\)

To highlight this restriction, an illustration may be considered where a lessor purchases an asset (for finance leasing) for GBP 10 million on the first day of the last quarter of the year. In such a case, for the year in which the asset is purchased, the qualifying expenditure (forming the basis for capital allowances) would be restricted to only GBP 2.5 million (i.e. 25% of the total expenditure of GBP 10 million, since the asset was owned by the lessor for only one quarter during the year).

It is important to note that the restriction is in terms of the amount of qualifying expenditure, rather than the rate at which capital allowances may be claimed. In the second year, the balance amount of capital expenditure (i.e. the amount of capital expenditure which was not allowed as qualifying expenditure in the year of acquisition - GBP 7.5 million in the illustration) would be treated as new qualifying expenditure.

3.5.2.4. Restrictions in the case of overseas/export leasing

In the case of plant or machinery that is the subject matter of the lease to an overseas lessee (except where the overseas lessee uses the said asset in its UK branch), capital allowances on the said asset may be subject to severe restrictions.\(^{128}\) Thus, this restriction may impede outbound double-dip leasing.

In the case of lease of plant or machinery to overseas lessees, generally, capital allowances would be restricted to 10% (instead of the normal 25%).\(^{129}\) Further, the capital expenditure on plant or machinery used for overseas leasing is allocated to a special class pool (referred to as “the overseas leasing pool”),\(^{130}\) and such a class pool is deemed to constitute a separate trade.

The capital allowances are altogether denied in the following cases:\(^{131}\)
- there is a gap of more than a year between the dates when two consecutive payments become due under the lease;
- any payments other than periodical payments are due under the lease, or under any agreement that might reasonably be construed as being collateral to it;
- any payment under the lease or under such a collateral agreement, expressed as a monthly amount over the period for which it is due, differs from any other such payment expressed in the same way, unless this is attributable to a change in:
  - the rate of corporation tax or income tax, or
  - the rate of capital allowances, or
  - any rate of interest linked to a change in the rate of interest applicable to inter-bank loans, or
  - any change in insurance premiums, charged by a person not connected with either the lessor or the lessee;

\(^{128}\) It is relevant to note that for this purpose, a reference to lease includes a sublease [Sec. 105(1)(b)].
\(^{130}\) Sec. 107(1) Capital Allowances Act 2001.
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- the lease is for more than 13 years\(^\text{132}\); or
- at any time, the lessor (or a connected person) will or may become entitled to receive from the lessee or any other person a payment (other than insurance money) of an amount determined prior to the expiry of the lease term that is based on the value of the plant and machinery on or after expiry of the lease term, even if such amount is independent of the actual disposal of the plant or machinery.

However, the above-stated restrictions do not apply in the case of wet leasing of a ship, aircraft or transport container and "short-term leasing"\(^\text{133}\).

For this purpose, to qualify as "short-term leasing", an asset must be leased:\(^\text{134}\)
(a) to the same person for less than 30 days at a time; and
(b) to the same person for less than 90 days in any 12-month period, or:
(i) to the same person for more than 365 days at a time; and
(ii) to a non-qualifying lessee,\(^\text{135}\) in aggregate, not exceeding two years in the designated period (normally ten years, but four years in the case of short-life assets).

3.5.2.5. Restriction in respect of free depreciation on the ships used for overseas leasing

While free depreciation is generally available in respect of the ships used for leasing, this benefit is denied to a lessor if the ship is used for overseas leasing at any time within ten years from ten years beginning with the date on which the lessor first brought the ship into use.\(^\text{136}\)

\(^{132}\) The lease is regarded as exceeding 13 years even in the case where the initial period of lease (under the main lease contract) is for less than 13 years, but there is a separate agreement that provides for extension or renewal of the lease, or for the grant of a new lease, so that the plant or machinery could be leased for a period exceeding 13 years.
\(^{135}\) For this purpose, broadly, "non-qualifying lessee" means a lessee who could not have obtained capital allowances (in the United Kingdom) on purchase of the asset.
3.5.2.6. Restrictions in the case of sale and finance leaseback arrangements

With effect from 2 July 1997, sale and finance leaseback of plant or machinery are subject to certain restrictions in respect of capital allowance entitlements. In the case of such transactions, the disposal value for the seller and the acquisition value for the buyer (i.e. the lessor in a sale-and-leaseback arrangement) are restricted to the lower of the following:  

(i) capital expenditure on the plant or machinery originally incurred by the seller;  
(ii) sale price of the plant or machinery;  
(iii) market value of the plant or machinery;  
(iv) notional written-down value incurred by the seller or a person connected with the seller.

For this purpose, the “notional written-down value” means the tax written-down value which would have been attributable to the plant or machinery, as if it was in a separate pool and as if the maximum available amount of capital allowance was claimed in each accounting period subsequent to the acquisition of the plant or machinery. The amount of notional written-down value is independent of whether or not the owner of the asset was entitled to claim capital allowances, and whether or not he had claimed such capital allowances.

3.5.2.7. Restrictions in the case of sale and finance leaseback on deceased terms

As per Sec. 225 of the Capital Allowances Act 2001, if:

- plant or machinery is sold and leased back under a finance lease; and
- as a part of the lease arrangement the greater part of the risk of non-compliance (by the lessee) is removed (e.g. by way of a defeasance arrangement, or by way of a bank guarantee),

the lessor is not entitled to the capital allowances on the said plant or machinery.  

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Normally, the greater part of non-compliance risk is regarded as removed if more than 50% of such risk is removed. The Inland Revenue, vide its Tax Bulletin No. 35 (June 1998), indicated that in its view this restrictive provision is applicable where the non-compliance risk is removed by more than 50% by way of:

- cash deposits or pledge of assets/income to secure obligations under the lease arrangements; or
- third-party guarantee or letter of credit, whether or not covered by a cash deposit or pledge of assets.

In the same Bulletin, the Inland Revenue clarified that the said restrictive provisions are not applicable in the case of a guarantee:

- provided by a person connected with the lessee;
- given jointly by a person connected with the lessee and a bank, provided that the connected person enjoys greater credit rating than the bank;
- provided by a bank which is in turn counter-guaranteed by a non-resident person connected with the lessee; the said person enjoys at least equal credit rating as the bank, but such credit rating is not established in the United Kingdom mainly for the reason that such person has been trading in the United Kingdom only for a short time; or
- where the lessor is part of a banking group, given by its parent bank to meet the capital adequacy requirements related to the large-exposures regime, provided that the guarantee is not a part of any wider arrangement.

3.5.3. Germany and the Netherlands

The tax laws in Germany and the Netherlands do not provide any leasing-specific restrictions.

3.5.4. Japan

In the case of a finance lease that is not deemed a sale/purchase transaction, the lessor is entitled to depreciation. However, if the lessee is a non-resident, and the leased assets are used in the lessee’s overseas business, then
the lessor is permitted to depreciate the leased asset only by using the straight-line method.\textsuperscript{139}

\footnote{139. See Akamatsu, Akira, "Japanese Tax Bureau's Bombshell Puts Leveraged Lease Market in a Tailspin", \textit{Tax Notes International Magazine} 25 November 1996.}