CHAPTER 4

INCOME RECOGNITION ASPECTS

4.1. Introduction

Generally, it may be possible for a lessor to defer tax liability in respect of leasing income by *rear-loading* the lease rental payments. Rear-loading of lease rentals could provide a significant tax advantage, as excess of tax depreciation over the low amount of taxable lease rental income would result in a tax (but not the real) loss during the early years in the lease term. Although rear-loading of lease rentals generates only deferred tax liability rather than elimination of tax liability, such deferral leads to a tax advantage on account of the “time value of money” principle.

Just as the combined effect of the lessor’s eligibility for substantial tax depreciation and the ability to defer income recognition in the early years results in a substantial tax advantage, presence of an effective anti-avoidance regime designed to counter deferral of income recognition could render a “tax-driven” leasing transaction “meaningless”.

As discussed in this chapter, an examination of the tax laws of the jurisdictions selected for the purposes of this study provides divergent results. While the Internal Revenue Code (combined with the Regulations) in the United States, and the Finance Act 1997 (Schedule 12) in the United Kingdom contain anti-avoidance rules to nullify tax advantages of a lease arrangement with uneven lease rentals, such anti-avoidance provisions are not necessary in Germany since, in any case, under German tax law income is generally recognized on an accrual basis in accordance with the German Generally Accepted Accounting Principles. On the other hand, Dutch tax law does not include anti-avoidance provisions to prevent a lessor from obtaining a tax advantage by receiving a greater amount of lease rentals during the later years of the lease term.

This chapter examines whether and how the tax laws of the select jurisdictions incorporate provisions with a view to counter the deferral of income recognition.

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140. I.e. by receiving greater part of the total lease rentals in the later part of the lease term.
4.2. Relevant income recognition rules in the United States (IRC Sec. 467 and Final Sec. 467 Regulations)

In the United States, tax advantages of a rear-loaded (as well as front-loaded) lease arrangement are effectively nullified by virtue of the provisions of IRC Sec. 467 and the Final Sec. 467 Regulations. The said provisions, particularly the Final Sec. 467 Regulations, are very detailed and exceedingly complicated. As a detailed discussion of the said provision does not appear necessary for the purposes of the present thesis, only the relevant core aspects of the said provisions are discussed briefly at 4.2.1. to 4.2.5. It is acknowledged that due to the complexity of the provisions, the said discussion may not appear "reader friendly". However, it is hoped that the said discussion clearly demonstrates the efficacy of the said provisions in eliminating the tax advantages of lease arrangements with uneven rentals (including prepaid or deferred rentals).

4.2.1. Applicability of IRC Sec. 467

IRC Sec. 467 applies only to the leases or other similar arrangements that constitute "Sec. 467 rental agreements". For this purpose, "Sec. 467 rental agreement" means a rental agreement for the use of tangible property under which:

- there is at least one rental amount allocable to a calendar year, that is to be paid after the close of the succeeding calendar year; or


142. Sec. 467 does not apply if the aggregate of the payments or value or any other consideration to be received for use of the asset does not exceed USD 250,000.

143. I.e. payable after the close of the calendar year following the calendar year in which the use of the property occurs.
Relevant income recognition rules in the United States
(IRC Sec. 467 and Final Sec. 467 Regulations)

- there are increasing amounts of rents payable under the agreement.\textsuperscript{144}

4.2.2. Consequences of applicability of Sec. 467: income
taxation on an accrual basis

In the case a lease agreement amounts to a Sec. 467 rental agreement, for
the tax treatment of the lessor as well as the lessee, the aggregate of the fol-
lowing amounts is taken into account on an “accrual basis”:
- the amount (present value) of rent which accrues during the relevant
tax year as determined in accordance with the relevant provisions\textsuperscript{145} of
IRC Sec. 467 and the Final Regulations (discussed at 4.2.3. below); and
- Sec. 467 interest for the tax year (discussed at 4.2.4. below).

For this purpose, the present values and interest amounts are determined by
applying 110% of the applicable federal interest rate, compounded semi-
annually.

4.2.3. Rent accruals under Sec. 467

4.2.3.1. Rent accrual in the case of agreements not perceived as “tax
avoidance transactions”

4.2.3.1.1. Relevant provision in IRC Sec. 461(b)(1)

As per IRC Sec. 467(b)(1), except in the case of certain perceived “tax
avoidance transactions”, the following amounts of rent are regarded as ac-
cruing during a taxable year:
(a) rent allocable to the taxable year in accordance with the Sec. 467 rental
agreement; plus

\textsuperscript{144} Although the definition of “Sec. 467 rental agreements” in IRC Sec. 467 covers
only increasing (but not decreasing) rents, the regulations issued under the said section
cover even agreements with decreasing rents. However, the regulations do not appear to
conflict with the IRC, as IRC Sec. 467(f) provides that under the regulations prescribed
by the Secretary, the rules comparable to the rules under Sec. 467 (i.e. in respect of agree-
ments with increasing rents) shall also apply in the case of any agreement where the
amount paid under the agreement for the use of the asset decreases during the term of the
agreement. A rental agreement has increasing or decreasing rent if the annualized fixed
rent allocated to any rental period exceeds the annualized fixed rent allocated to any
other rental period in the lease term.

\textsuperscript{145} Particularly, IRC Sec. 467(b).
Chapter 4 – Income recognition aspects

(b) rent payable after the close of the tax year, which is determined under the Final Regulations as pertaining to the relevant tax year.

In this regard, the Regulations prescribe rather complex computation rules, as briefly discussed in 4.2.3.1.2.

4.2.3.1.2. Rent computation formulae prescribed under the Regulations

(a) The general rent computation formula

Reg. 1.467-1(d)(1) defines the Sec. 467 rent for a tax year as the aggregate of:
- the fixed rent\(^{146}\) for any rental period (determined under Reg. 1.467-1(d)(2)) that begins and ends in the taxable year;
- a ratable portion of the fixed rent for any other rental period beginning or ending in the taxable year;\(^{147}\) and
- in the case of a Sec. 467 rental agreement that provides for contingent rent,\(^{148}\) the contingent rent that accrues during the taxable year.

(b) Rental accrual in the case of agreements providing for adequate interest on fixed rent

In the case of a Sec. 467 rental agreement that is not perceived as a tax avoidance transaction, the fixed rent for a rental period is the amount of fixed rent allocated to the rental period under the agreement, if the agreement provides for adequate interest on the fixed rent.

As per the Regulations, an agreement is regarded as providing adequate interest on fixed rent if:
- the rental agreement has no deferred or prepaid rent;\(^{149}\)

\(^{146}\) Reg. 1.467-1(h)(3) defines the term “fixed rent” to mean, subject to certain rules, any rent to the extent its amount and the time at which it is required to be paid are fixed and determinable under the terms of the rental agreement as of the lease date.

\(^{147}\) I.e. the amount of fixed rent corresponding to a rental period falling partly in the relevant taxable year, and partly in another taxable year.

\(^{148}\) As per Reg. 1.467-1(h)(2), “contingent rent” means any rent that is not fixed rent, including any amount reflecting an adjustment based on a reasonable price index or a variable interest rate provision.

\(^{149}\) Deferred rents occur if the cumulative amount of rent allocated as of the close of a calendar year exceeds the cumulative amount of rent payable as of the close of the succeeding calendar year. Conversely, prepaid rent exists if the cumulative amount of rent payable as of the close of a calendar year exceeds the cumulative amount of rent allocated as of the close of the succeeding calendar year.

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Relevant income recognition rules in the United States
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- the rental agreement has deferred or prepaid rent, but it appropriately\textsuperscript{150} provides for interest;
- the rental agreement provides for deferred rent but no prepaid rent, and the aggregate of the present values of all amounts payable by the lessee as fixed rent (and interest, if any, thereon) is equal to or greater than the sum of the present values of the fixed rent allocated to each rental period;
- the rental agreement provides for prepaid rent but no deferred rent, and the sum of the present values of all amounts payable by the lessee as fixed rent, plus the sum of interest\textsuperscript{151} payable by the lessor to the lessee as interest, if any, on prepaid fixed rent, is equal to or less than the sum of the present value of the fixed rent allocated to each rental period.

(c) \textit{Rental accrual in the case of agreements not providing for adequate interest on fixed rent (proportional rental accrual formula)}

If the Sec. 467 rental agreement does not provide for adequate interest on fixed rent, the “proportional rental amount” is deemed the fixed rent. The proportional rental amount is determined by the following formula:

\[
\text{amount of fixed rent allocated to the rental period}\textsuperscript{152} \times \left(\frac{A}{B}\right)
\]

where:

\[A = \text{the aggregate present values of fixed rent payable under the agreement, and interest thereon}\]
\[B = \text{the aggregate present values of fixed rent payable under the agreement}\]

4.2.3.2. Rent accrual in the case of perceived “tax avoidance transactions”

4.2.3.2.1. \textit{Tax treatment of rents under the perceived “tax avoidance transactions”}

In the case of a Sec. 467 rental agreement which is perceived as a transaction with the principal motive of tax avoidance, a “constant rental amount”

\textsuperscript{150} In accordance with the conditions prescribed in Reg. 1.467-2(b)(ii).
\textsuperscript{151} I.e. the negative present values of all amounts payable by the lessor to the lessee.
\textsuperscript{152} I.e. the amount of fixed rent allocated to the rental period, as defined in 4.2.3.1.2.(a) above (disregarding the computation formula for proportional rental amount).
is deemed to be the rent accruing during the tax year.\textsuperscript{153} For this purpose, the "constant rental amount" means the amount which, if paid at the end of each lease year, would result in an aggregate present value equivalent to the present value of the aggregate payments required under the agreement. In other words, the "constant rental amount" is determined by applying a mathematical process of apportioning the total rental payments under the agreement in a manner such that the present values of the payments so apportioned would equal the present value of the total rentals payable under the agreement. For determining the present values a discounting factor equivalent to 110\% of the applicable federal rate is used.

\textbf{4.2.3.2.2. Meaning of the perceived "tax avoidance transactions"}

For the purposes of Sec. 467, perceived "tax avoidance transactions" include:

- disqualified leaseback agreements;
- disqualified long-term agreements; and
- agreements that do not provide for allocation of rents to the various lease periods.\textsuperscript{154}

\textit{Disqualified leaseback agreement.} A "disqualified leaseback agreement" means a Sec. 467 rental agreement that is a part of a leaseback transaction involving increasing rents with the principal purpose of tax avoidance. A transaction is regarded as a leaseback transaction if it involves a leaseback to any person (or to a related person) who had an interest in the asset any time within two years before such leaseback.

\textit{Disqualified long-term agreement.} An agreement is regarded as a "disqualified long-term agreement" if it is for a term exceeding 75\% of the statutory recovery period for the asset, and the agreement provides for increasing rents with the principal purpose of tax avoidance.

\textsuperscript{153} It is relevant to note that "constant rental amount" method can be applied only by the IRS, upon determination that tax avoidance was the principal motive behind the transaction; the taxpayer cannot apply this method on its own.

\textsuperscript{154} As per Reg. 1.467-1(c)(2), a rental agreement is regarded as specifically allocating fixed rent if it unambiguously specifies, for a period no longer than a year, a fixed amount of rent for which the lessee is liable on account of the use of the property during that period, and the aggregate of fixed rent specified equals to the total amount of fixed rent payable under the lease.
4.2.4. Sec. 467 interest

Sec. 467 interest comprises the aggregate of:

- the interest on fixed rent for any rental period that begins and ends in the taxable year;
- a ratable portion of the interest on fixed rent for any other rental period beginning or ending in the taxable year; and
- in the case of a Sec. 467 rental agreement that provides for contingent rent, any interest that accrues on the contingent rent during the taxable year.

For this purpose, interest on fixed rent for a rental period is equal to the product of (a) the principal balance of a Sec. 467 loan at the beginning of the rental period and (b) the yield of the Sec. 467 loan.

4.2.5. Safe-harbour provisions

The Final 467 Regulations provide for safe-harbour provisions, the most important of which is “the 90-110% test”. As per the said provision, the lease rent in the case of a Sec. 467 lease agreement would not be recalculated on the basis of the above-stated accrual method of accounting if the rent allocated to each calendar year is not less than 90% nor more than 110% of the average annual rent (i.e. the total rent for the entire lease term, divided by the number of calendar years in the entire lease term). In the case

155. Section 467 loan is deemed non-existent if the section 467 rental agreement provides adequate interest as discussed at 4.2. In the cases involving Sec. 467 loan, as per Reg. 1.467-4(B)(1), subject to certain exceptions, the principal balance of the section 467 loan at the beginning of a rental period is calculated as follows:

the fixed rent accrued in the preceding rental periods;

(+) the interest on fixed rent includible in the gross income of the lessee for preceding rental periods;

(+) any amount payable by the lessee on or before the first day of the rental period as interest on the prepaid fixed rent;

(−) the interest on prepaid fixed rent includible in the gross income of the lessee for the preceding rental periods;

(−) any amount payable by the lessee on or before the first day of the rental period as fixed rent or interest thereon;

(=) the principal balance of the Sec. 467 loan at the beginning of the rental period.

156. As per Reg. 1.467-4(c)(1), subject to a few exceptions, the yield is the discount rate at which the sum of the present values of all amounts payable by the lessee as fixed rent and interest on fixed rent, plus the sum of the present values of all amounts payable by the lessor as interest on prepaid fixed rent, equals the sum of the present values of the accrued fixed rent.
of long-term real property leases, however, the permitted deviation from the average annual rent is 15%, so that the test becomes 85-115% instead of 90-110%.

4.3. Relevant income recognition rules in the United Kingdom

4.3.1. Taxation of operating lease rental income

The rules of taxation of rental income from an operating lease are fairly simple. The gross rental income from an operating lease is regarded as taxable income (subject to the deduction for capital allowances and other business expenses related to the income), subject to the normal/general tax rules for income recognition. Unlike for finance leases, there are no specific anti-abuse provisions for income recognition in respect of the operating leases.

4.3.2. Taxation of finance lease rental income

4.3.2.1. Background

Finance Act 1997, through Schedule 12, introduced the rules for taxation of the finance lease income that, in certain cases, could affect the basis of taxation of the finance lease income, as compared to the implications prior to the introduction of the said rules.

4.3.2.2. Return of investment in capital form

Part I of Schedule 12 contains the rules for taxation of amounts received by the lessor (or related parties), which could have previously escaped taxation on account of the return of non-taxable capital.

157 For a description of the UK tax treatment of the lease rentals, see PricewaterhouseCoopers, Leasing in the UK (4th Edition) (Tolley LexisNexis), Chapter 22.
Prior to the introduction of Schedule 12, it was possible to structure the transactions whereby the lessee would make capital payments to the finance lessor for exercise of an option to purchase the leased asset before the end of the lease term. Part I of the Schedule 12 seeks to nullify the tax advantages of such transactions.

Part I of the Schedule 12 applies where the following five conditions are satisfied:

1. under normal accounting practice the leasing arrangement is treated as a finance lease or loan in the accounts of the lessor or the lessor’s group;
2. under the leasing arrangements the lessor (or a connected party) is entitled to receive a “major lump sum” that is not rent but is treated partly as income and partly as capital for accounting purposes;
3. not all of that part of the major lump sum that would be treated as income for accounting purposes would be treated as taxable income under the old rules;
4. negative depreciation has arisen during the current or earlier accounting period of the present lessor; and
5. the lessee (or related party) is entitled to acquire the leased asset from the lessor (or related party) in return for a “qualifying lump sum”; or circumstances exist under which it is more likely than not that the lessee will acquire the asset before that asset is acquired by a person other than the lessor in a sale on the open market.

Unless all the above-stated five conditions are satisfied simultaneously during an accounting period for the current lessor, Schedule 12 Part I would not apply. As regards the condition (No. 4) relating to the negative depreciation, however, once the negative depreciation has arisen in an accounting period, this condition is deemed to be fulfilled for all future periods (for the same/current lessor).

Once all five conditions are satisfied in an accounting period, they are deemed to be fulfilled even for all future periods, until:

- the lease comes to an end; or
- the lease is assigned to a person who is not connected with:
  - the assignor;
  - any previous lessor; or
  - any future lessor under arrangements made by the lessor (or a related party) at some time before the assignment.
Where Part I of Schedule 12 applies, any "major lump sum" is brought within the charge of corporation tax, generally by recapture of the capital allowances previously granted.

4.3.2.3. Negative depreciation

Until 26 November 1996, a finance lessor’s rental income was taxable as and when receivable.

Since the early 1990s the Inland Revenue became increasingly concerned about the tax deferral of lease rental income. The inconclusive discussion between the Financing and Leasing Association (on behalf of lessors) and the Inland Revenue culminated in the introduction of complex rules (vide Finance Act 1997, Schedule 12 Part 2) for taxation of the finance lease rental income on the basis of the accrual principle.

With a view to reduce the tax deferral advantage in a deferred finance lease, the Finance Act 1997, Schedule 12, Part 2 treats the greater of (a) accountancy rental earnings and (b) the normal rent as the minimum taxable income of a lessor.

Schedule 12, part 2 applies to any accounting period in which the accountancy rental earnings exceed the “normal rent”.

In the United Kingdom, the excess of the accountancy rental earnings over normal rent is commonly referred to as “negative depreciation”, although it is neither negative nor depreciation. Since the negative depreciation is based on the accountancy rental earnings, it leads to “cumulative accountancy rental excess” in the later part of the lease term. In the absence of a

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159. "Major lump sum" is defined in paragraph 3(2) of Part I of Schedule 12 to mean "a sum which is not rent but ... falls ... to be treated under normal accountancy practice as to part as repayment of some or all of the investment in respect of a finance lease or loan and as to part a return on investment in respect of a finance lease or loan". The sum must comprise both the income and the capital element from an accounting perspective, but must not be rent.

160. I.e. the finance lease rental income recognized in the books of account in accordance with the Statement on Standard Accounting Practices (SSAP) 21.

161. I.e. the rent payable in accordance with the lease agreement, during the relevant accounting period.

relief provision, the taxation of negative depreciation would lead to double taxation, as the normal rent would exceed the accountancy rental earnings in the later part of the lease term. The cumulative accountancy rental excess is relieved by way of the setoff of the excess against taxable rents. The amount that is set off goes to reduce the cumulative accountancy rental excess available in future periods. The following illustration would highlight the point:

<table>
<thead>
<tr>
<th>Period</th>
<th>&quot;Normal rent&quot; (NR)</th>
<th>&quot;Accountancy rental earnings&quot; (ARE)</th>
<th>Taxable before relief for CARE b/f</th>
<th>Relief for CARE b/f</th>
<th>Taxable after relief for CARE b/f</th>
<th>Cumulative accountancy rental excess (CARE) c/f</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>500</td>
<td>1,900</td>
<td>1,400 (ARE)</td>
<td>nil</td>
<td>1,900</td>
<td>1,400</td>
</tr>
<tr>
<td>2</td>
<td>800</td>
<td>1,800</td>
<td>1,800 (ARE)</td>
<td>nil</td>
<td>1,800</td>
<td>1,400 + 1,000 = 2,400</td>
</tr>
<tr>
<td>3</td>
<td>1,200</td>
<td>1,700</td>
<td>1,700 (ARE)</td>
<td>nil</td>
<td>1,700</td>
<td>2,400 + 500 = 2,900</td>
</tr>
<tr>
<td>4</td>
<td>1,700</td>
<td>1,550</td>
<td>1,700 (NR)</td>
<td>150*</td>
<td>1,550</td>
<td>2,900 – 150 = 2,750</td>
</tr>
<tr>
<td>5</td>
<td>2,300</td>
<td>1,350</td>
<td>2,300 (NR)</td>
<td>950*</td>
<td>1,350</td>
<td>2,750 – 950 = 1,800</td>
</tr>
<tr>
<td>6</td>
<td>3,000</td>
<td>1,200</td>
<td>3,000 (NR)</td>
<td>1,800</td>
<td>1,200</td>
<td>1,800 – 1,800 = nil</td>
</tr>
<tr>
<td>Total</td>
<td>9,500</td>
<td>9,500</td>
<td>9,500</td>
<td></td>
<td></td>
<td>9,500</td>
</tr>
</tbody>
</table>

* Restricted to the excess of the normal rent over the accountancy rental earnings.

The cumulative accountancy rental excess may also be relieved against capital gains, where the lessor disposes of its entire interest in the leased asset for a capital amount.

It is relevant to note that, as discussed at 5.4.5.2., unlike in the case of the US IRC Sec. 467 combined with the Final Sec. 467 Regulations, the provisions of the UK Finance Act 1997 are not adequate to completely eliminate the tax advantage from a rear-loaded lease transaction.

### 4.4. Relevant income recognition rules in Germany

As per German tax law, taxpayers engaged in a business are obliged to prepare financial statements (for tax purposes) in accordance with the Finan-
As per the "accrual principle" of the German Generally Accepted Accounting Principles, the annual financial statements must be prepared on an accrual basis, so that income and expenses must be recognized as and when they occur, regardless of the time when the expenses are paid or the income is received. Accordingly, even where a lease contract provides for uneven rental payments over the lease term, the income from such a lease arrangement is recognized on an accrual basis. Thus, the accounting principles influence the income recognition for tax purposes. Accordingly, a lease arrangement with uneven rental payments does not provide any tax advantage in Germany.

4.5. Relevant income recognition rules in the Netherlands

Unlike the US and the UK tax systems, the Dutch tax system does not contain any anti-avoidance tax provisions to neutralize the tax advantage of a lease arrangement with uneven rental payments.

4.6. Relevant income recognition rules in Japan

In Japan, subject to certain statutory adjustments, profit (before tax) as per the financial statements prepared in accordance with the Japanese Generally Accepted Accounting Principles (GAAP) is treated as taxable income. Thus, the GAAP aspects concerning income recognition are crucial for determining the amount of taxable lease rental income.

For financial accounting purposes, lease rental income is recognized in the following manner:

- A finance lease involving transfer of ownership in the leased asset is treated as a transaction involving sale of the said asset. As a consequence, the gross lease rental is bifurcated into principal (sale price) and interest.

163. Sec. 140 AO; see Amann, German Tax Guide, p. 610.
164. See PricewaterhouseCoopers, International Leasing (2nd Edition) (Tolley LexisNexis), paragraph 5.2.2.1 (Chapter for Germany).
165. See, for the basis of computation of taxable income, PricewaterhouseCoopers, International Leasing (2nd Edition) (Tolley LexisNexis), paragraphs 5.3.1, 5.3.4 and 5.3.5.
Relevant income recognition rules in Japan

In the case of operating leases and finance leases not involving the transfer of ownership, income is recognized on the basis as and when it falls due over the lease term.\textsuperscript{168}

Accordingly, it is possible to obtain a tax advantage in Japan in the case of a lease arrangement stipulating uneven rental payments over the lease term.

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