International taxation of cross-border leasing income
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CHAPTER 5
LIMITS OF TAX-DRIVEN CROSS-BORDER LEASING TRANSACTIONS

5.1. Introduction

Over the past few decades, taxpayers have engaged in tax-driven leasing transactions for maximizing tax advantages. The tax advantages sought to be derived from the leasing transactions could be in the form of enhancement of deductions (for instance, depreciation, interest deduction, etc.) or deferment of taxable leasing income, or a combination of enhancement of deductions as well as deferral of income.

In their pursuit of maximizing tax advantages, particularly with respect to big-ticket assets, taxpayers often prefer aggressive leasing transactions. Analytical review of the various transaction structures suggests the possibility of grouping the tax-driven leasing transaction structures as structures designed to:
- exploit the transaction characterization rules of the national tax laws (e.g. sale-and-leaseback, double-dip transactions, etc.);
- facilitate the deferral of taxation of leasing income (e.g. leases with balloon rental payments);
- circumvent the restrictive or anti-avoidance provisions of a tax law (e.g. chain-lease, replacement lease and lease-in-lease-out transactions);
- facilitate the transfer of tax advantages to equity investors in the lessor entity (e.g. organizing the lessor entity in the form of transparent entities);
- avail of certain beneficial provisions of tax laws or tax treaties (e.g. structures to benefit from the tax sparing credit provisions in tax treaties); and
- enhance tax advantages by increasing a lessor's capacity to lease (e.g. leveraged leases with non-recourse financing, defeasance structures, etc.).

The tax laws of many jurisdictions have specific restrictive or anti-avoidance provisions to impede aggressive leasing transactions. However, due to the dynamic characteristic of the financial services industry, the players in
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the leasing arena have been able to innovate the transaction structures beyond the clutches of such restrictive or anti-avoidance provisions, that are inevitably followed by consequential amendments in the national tax laws to plug loopholes. However, the plugging of the said loopholes is often found not pre-emptive enough to check further innovation of the leasing transaction structures. In such cases the only remedy available to the tax authorities is to invoke the general anti-avoidance rules, though they may not always prove effective.

This chapter aims to explore the current limits of the tax-driven leasing transactions by analysing:
(i) the relevant general anti-avoidance principles in the select jurisdictions;
(ii) the types of tax-driven leasing transaction structures commonly undertaken by taxpayers; and
(iii) specific provisions under the national tax laws or court decisions that may have influence on such transaction structures.

5.2. Relevant anti-avoidance rules in select jurisdictions: a brief overview

5.2.1. United States

The IRC does not specifically include a general anti-avoidance rule.\(^\text{169}\) However, the United States being a common law jurisdiction, substantial tax jurisprudence on the subject of tax avoidance has developed as a result of court decisions.\(^\text{170}\) The general anti-avoidance principles in the United States may be classified into the following doctrines:
(a) the sham transaction doctrine;
(b) the step transaction doctrine;
(c) the business purpose doctrine;
(d) the substance-over-form doctrine; and
(e) the economic substance doctrine or the economic sham transaction doctrine.

\(^{169}\) See Streng, Yoder, “Form and Substance in Tax Law” (Chapter for the United States, paragraph 5.4), Cahiers de droit fiscal international, Volume LXXXVIIa, IFA 2002 Congress, Oslo.

\(^{170}\) See Streng, Yoder, “Form and Substance in Tax Law” (Chapter for the United States, paragraph 5.3), Cahiers de droit fiscal international, Volume LXXXVIIa, IFA 2002 Congress, Oslo.
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It is important to note that these doctrines are not mutually exclusive, and the IRS may seek to neutralize an aggressive transaction by invoking more than one doctrine.

5.2.1.1. The sham transaction doctrine

A sham transaction could be either a “factual sham” transaction or an “economic sham” transaction. A transaction is regarded as factual sham, when the factual events occurring in the course of a transaction are inconsistent with the transaction described by the taxpayer in the relevant documents. In other words, a transaction is regarded as a factual sham if it is found to be “fake”.

This doctrine covers only the factual sham transactions, and the economic sham transactions are covered under the economic substance doctrine. In cases where the sham transaction doctrine applies, the relevant transaction documents are disregarded and the transaction is considered non-existent for tax purposes.

5.2.1.2. The step transaction doctrine

Under the step transaction doctrine, separate transactions within a series of transactions are treated as one composite transaction, if such a treatment more accurately reflects the underlying substance of the transactions. In this regard, the US Supreme Court decision in *Minnesota Tea Co. v. Helvering* is considered an authority.

It appears that for ascertaining whether the step transaction doctrine applies to a particular series of transactions, the US courts have applied three main tests, namely:

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171. For that reason, the economic substance doctrine is also referred to as “economic sham transaction doctrine”.
172. For a detailed discussion on this doctrine, see Streng, Yoder, “Form and Substance in Tax Law” (Chapter for the United States, paragraph 5.7.4), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.
173. 302 US 609 (1938). In this decision, the Supreme Court coined the step transaction doctrine by stating that a given result at the end of a straight path does not change by taking a devious path.
(i) the binding commitment test;
(ii) the mutual interdependence test; and
(iii) the end result test.

A series of transactions can be combined as one composite transaction under the binding commitment test if, at the time of the first transaction the taxpayer was under a binding obligation to follow the other transactions. Conversely, in absence of such binding obligation on the taxpayer, a series of transactions cannot be combined as one composite transaction unless the other two tests under this doctrine apply.\(^{175}\)

Under the mutual interdependence test, a series of transactions can be clubbed together as one composite transactions if the relationship between the two or more transactions is such that the legal relationship arising from one transaction would have been meaningless without undertaking the other transactions within the series.\(^{176}\)

Under the end result test, a series of transactions can be combined as one transaction if so intended by the parties to the transactions. Apparently, this third test resembles the “substance-over-form doctrine”.\(^{177}\)

5.2.1.3. Business purpose doctrine

Under the business purpose doctrine, a transaction or a series of transactions is disregarded if the transaction lacks a valid business purpose other than avoidance of federal tax. *Gregory v. Helvering*\(^{178}\) is the leading authority on this doctrine, wherein the US Supreme Court disregarded a corporate

\(^{175}\) The US Supreme Court decision in *Commissioner v. Gordon* 391 US 83 (1968). In this case, a corporation distributed 57% of the stock of its wholly owned subsidiary to its shareholders and informed the shareholders that it intended to distribute the remaining 43% stock within the next few years. Two years subsequent to the first distribution, when the corporation distributed the remaining 43% stock, the taxpayer claimed that the two distributions should be combined as one transaction so as to treat it as a tax-free reorganization. Rejecting the claim of the taxpayer, the Court held that for a transaction to be characterized as first step in a composite transaction there must exist a binding commitment in respect of the later step.


\(^{177}\) For a discussion on step transaction doctrine, see Streng, Yoder, “Form and Substance in Tax Law (Chapter for the United States, paragraph 5.7.1), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.

\(^{178}\) 293 US 465 (1935).
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reorganization for want of an underlying business purpose. The following extract from the decision forms the genesis of the doctrine:

When [the statute] speaks of a transfer of assets by one corporation to another, it means a transfer made “in pursuance of a plan of reorganization” of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here ... [T]he transaction upon its fact lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.¹⁷⁹

5.2.1.4. The substance-over-form doctrine

Under the substance-over-form doctrine, the tax authorities or a court may recharacterize a transaction in accordance with its economic substance, if the legal form of the transaction does not reflect its true economic substance.¹⁸⁰

In *Gregory v. Helvering*,¹⁸¹ the US Supreme Court disregarded the legal form (corporate reorganization) and held that, in substance, the transaction was in respect of dividends of appreciated securities taxable as ordinary income of the taxpayer.¹⁸²

5.2.1.5. The economic substance or the economic sham transaction doctrine

Under this doctrine, a taxpayer is denied a tax advantage if the economic substance of the transaction is insignificant compared to the tax advan-

¹⁷⁹. For a discussion on business purpose doctrine, see Streng, Yoder, “Form and Substance in Tax Law” (Chapter for the United States, paragraph 5.7.2), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.
¹⁸⁰. For a discussion on substance over form doctrine, see Streng, Yoder, “Form and Substance in Tax Law” (Chapter for the United States, paragraph 5.7.3), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.
¹⁸². *ASA Investerings Partnership v. Commissioner* (T.C. Memo 1998-305, aff’d. 201 F.3d 505 (2000), cert. denied, 531 US 87) is a recent case where the Court applied the substance-over-form doctrine to recharacterize a transaction.
tage.\textsuperscript{183} \textit{Goldstein v. Commissioner}\textsuperscript{184} is one of the early cases where a trans-
action was disregarded due to lack of economic substance.

\textit{ACM Partnership v. Commissioner}\textsuperscript{185} is another leading case where a trans-
action (purchase and sale of a property within a 24-day period) was disre-
garded for want of economic substance. However, in \textit{United Parcel Service v. Commissioner}\textsuperscript{186} the Court of Appeals (11th Circuit) respected a transac-
tion as the taxpayer was able to demonstrate economic substance in the
transaction challenged by the IRS.

As various federal courts of appeal in the United States are organized in dif-
f erent circuits, the decisions of one federal court of appeal are not binding
on the other federal courts of appeal. Accordingly, it is possible that two
federal courts of appeal may reach contrasting conclusions on the same is-
ssue. This aspect could be best appreciated by comparing the outcome of
comparable dividend-stripping transactions in \textit{Compaq Computer Corp. v. Commissioner}\textsuperscript{187} and \textit{IES Industries Inc. v. United States}.\textsuperscript{188}

In \textit{Compaq Computer Corp. v. Commissioner}, the taxpayer acquired “cum
dividend” certain American Depository Receipts (ADRs) issued by Royal

\textsuperscript{183} For a discussion on this doctrine, see Streng, Yoder, “Form and Substance in Tax
Law” (Chapter for the United States, paragraph 5.7.A), Cahiers de droit fiscal international,
Volume LXXXVIIa, IFA 2002 Congress, Oslo.

\textsuperscript{184} 364 F.2d 734 (2nd Cir. 1966). In this case, the taxpayer sought to derive a tax de-
ferral benefit by taking a loan involving prepaid interest to invest in US Treasury secur-
ities that did not involve prepaid interest. As the transaction lacked economic substance
and the only underlying purpose was to obtain a significant amount of tax deduction (to
set off against sweepstakes winnings by the taxpayer), the Court disregarded the trans-
action.

\textsuperscript{185} T.C. Memo 1997-115, aff’d. in part and reversed in part, 157 F.3d 231 (3rd Cir.
1998), Cert. denied 526 US 1017 (1999). In this case, the Court of Appeals remarked
about the transaction that “viewed according to their objective economic effect rather
than their form, transactions involved only a fleeting and economically inconsequential
investment in and offsetting divestment from the [debt instruments] ... The transac-
tions with respect to the [debt instruments] left the [taxpayer] in the same position it had oc-
cupied before engaging in the offsetting acquisition and disposition of those notes.”

\textsuperscript{186} 254 F.3d 1014 (11th Cir. 2001). In this case, the package delivery service company
United Parcel Services (UPS) formed a subsidiary in Bermuda which assumed (for com-
ensation) certain UPS risks for lost or damaged parcels. The IRS sought to disregard the
transaction between UPS and the Bermuda subsidiary and tax profits of the Bermuda
subsidiary as income of UPS. UPS was successful in arguing before the Court of Appeals
that its transaction with the Bermuda subsidiary had economic substance and it com-
prised a genuine exchange of obligations between two real and independent entities. On
that ground, the Court of Appeals respected the transaction.

\textsuperscript{187} 277 F.3d 778 (5th Cir. 2001).

\textsuperscript{188} 253 F3d 350 (8th Cir. 2001).
Dutch Petroleum and sold the same “ex dividend” within an hour of the acquisition. Though the transaction could not be expected to yield any economic benefit, the taxpayer sought to acquire foreign tax credits to the extent of USD 3.4 million and set off the capital loss (for tax purposes) produced by the transaction against another taxable capital gain. The Tax Court disregarded the transaction due to lack of economic substance. On further appeal by the taxpayer, the Court of Appeals (5th Circuit) commented that the transaction did not involve a bona fide business purpose and the Court was not persuaded that Congress intended to encourage or permit a transaction that merely manipulated the foreign tax credit system to achieve US tax savings.

IES Industries Inc. v. United States involved a similar dividend stripping transaction. However, unlike in Compaq Case, the Court of Appeals (8th Circuit) respected the transaction.

5.2.1.6. The US Supreme Court decision in the Frank Lyon case

In the context of respectability of the legal form of a lease transaction, the following observations made by the US Supreme Court reflect the relevant principle:

"Where there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts. It suffices to say that a sale-and-leaseback, in and of itself, does not necessarily operate to deny a taxpayer's claim for deductions."

189. As the ADRs were sold “ex dividend”, the taxpayer fetched a lower price as compared to the price it had paid for purchasing the ADRs “cum dividend”. This difference resulted in a capital loss for tax purposes, though, in reality, the taxpayer did not incur any loss as the “capital loss” represented the dividend value in the ADRs which the taxpayer encashed before selling the ADRs.

190. 435 US 561.
5.2.1.7. Application of “two-fold test” by the lower courts in the United States

In recent cases, as discussed hereafter, the lower courts have applied the following two tests to determine whether a transaction should be respected as a lease for federal income tax purposes:

(i) whether the transaction is not a sham devoid of economic substance ("sham transaction test"); and

(ii) whether the lessor has acquired and retained the requisite burdens and benefits of ownership of the leased property ("burden and benefits of ownership test").

Where both the tests show a positive result, generally the courts have respected the transactions as a lease.

(i) Sham transaction test

The “sham transaction test” consists of a factual analysis. In recent cases, the courts have focused on the economic substance of the transactions. The economic substance analysis consists of an examination of the objective factors indicating whether the taxpayer had a reasonable opportunity to receive economic profit from the transaction, apart from any tax benefit.

In one case, the Tax Court considered the following factors as significant in analysing whether a transaction has economic substance apart from tax benefits:

- presence (or absence) of arm’s length price negotiations;
- relationship between the sale price and the fair market value;
- financial structure of the transaction;
- degree of adherence to contractual terms; and
- reasonableness of the income and residual value projections.

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192. See Shriver v. Commissioner, 899 F.2d 905 (10th Cir. 1990); Casebeer v. Commissioner, 862 F.2d 1486 (11th Cir. 1989); Rose v. Commissioner, 868 F.2d 851, 854 (6th Cir. 1989).
(ii) Burden and benefits of ownership test

Generally, for a lease transaction to be respected, the lessor must have the “upside” (profit and appreciation benefits) and “downside” (risk of loss) with respect to the property. 194

5.2.2. United Kingdom

In the United Kingdom, tax consequences are determined by the legal form of a transaction, unless such result would conflict with the general or specific anti-avoidance rules (the general anti-avoidance principles are developed by the judge-made common law). 195 As specific anti-avoidance provisions may not be pre-emptive enough to check the aggressive tax-driven leasing transactions, the general anti-avoidance principles define the boundaries of freedom that a taxpayer may reasonably assume in “designing” the legal form of leasing transactions. The general anti-avoidance principles emerging from various court decisions could be encapsulated as follows:

5.2.2.1. The Ramsay principle (W.T. Ramsay v. IRC) 196

In the landmark case of W. T. Ramsay v. IRC, the House of Lords established the principle that a court is not compelled to look at a document or a transaction in isolation, divorced from the context to which it properly belongs. If a document or transaction was intended by the parties to it to have a particular effect as part or nexus of a series of transactions, or as an element in a wider transaction intended by the taxpayer to operate as a whole, then the court is not obliged to view the document or the transaction in accordance with the purported legal effect; and the court is free to consider the transaction in accordance with the intended effect. This principle is now commonly referred to as the Ramsay principle.

194. See observations of the Supreme Court in Frank Lyon Co. v. United States, 435 U.S. 561; Sun Oil Co. v. Commissioner, 562 F.2d 258 (3rd Cir. 1977), cert. Denied, 436 U.S. 944 (1978); Emershaw v. Commissioner, 59 T.C.M. (CCH) 621 (1990), aff’d, 917 F.2d 1040 (8th Cir. 1990); Levy v. Commissioner, 91 T.C. 838 (1988).
195. See Ballard, Richard, and Davison, Paul, “Form and Substance in Tax Law” (Chapter for the United Kingdom), Cahiers de droit fiscal international, Volume LXXXVIIa, IFA 2002 Congress, Oslo.
In *Ramsay*, the House of Lords also emphasized that the tax authorities and the courts are not obliged to take a piecemeal approach towards the component steps forming part of a composite transaction.\(^{197}\)

### 5.2.2.2. The step-transaction doctrine (*Furniss v. Dawson\(^{198}\) and *Craven v. White\(^{199}\)*)

In *Furniss v. Dawson*, the House of Lords fine-tuned the Ramsay principle and held that in case of a preordained series of transactions intended to operate as such, the fiscal consequences must be ascertained by considering the aggregate result of the series as a whole, and not by dissecting the scheme and considering each individual transaction separately.\(^{200}\)

In *Craven v. White*, the House of Lords explained that a court must determine the tax consequences of a series of transactions in a three-step manner, as follows:

(i) first, a court must construe the relevant statute in order to ascertain its meaning;

(ii) next, it must analyse the series of transactions in question, regarded as a whole, so as to ascertain its true legal effect; and

(iii) finally, it must apply the statute as construed in accordance with the true legal effect of the series of transactions.

### 5.2.2.3. Trading transactions v. transactions with the sole objective of obtaining tax advantage (*Overseas Containers (Finance) Ltd. v. Stoker (Inspector)*\(^{201}\) and *Lupton v. F.A. & A.B. Ltd.*\(^{202}\))

In *Overseas Containers (Finance) Ltd. v. Stoker (Inspector)*, the Court of Appeals held that a transaction can be regarded as a trading transaction only

\(^{197}\) For a discussion on the Ramsay principle, also see Ballard, Richard, and Davison, Paul, "Form and Substance in Tax Law" (Chapter for the United Kingdom, paragraph 2.2), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.

\(^{198}\) 1984) 1 All ER 530.

\(^{199}\) 1988) 3 All ER 495 (HL).

\(^{200}\) For a discussion on *Furniss v. Dawson and Craven v. White*, also see Ballard, Richard, and Davison, Paul, "Form and Substance in Tax Law" (Chapter for the United Kingdom), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.

\(^{201}\) 1991) 188 ITR 383 (CA).

\(^{202}\) [1972] AC 634 (HL).
if it embodies an underlying commercial purpose; and once a transaction is found to be a trading transaction, the existence of a collateral objective of obtaining a tax advantage would not denature it. However, if the facts demonstrate that the sole purpose behind a transaction was to derive a tax advantage, then as a matter of law, it could not be regarded as having been undertaken for a commercial purpose and hence could not be treated as a trading transaction.

*Lupton v. F.A. & A.B. Ltd.* involved a dividend-stripping transaction (by a share dealer), devoid of any commercial purpose, undertaken for the sole object of deriving a tax advantage. The House of Lords was required to decide whether such a transaction could be regarded as a trading transaction. The House of Lords unanimously held that since the transaction was carried out for the sole purpose of deriving a tax advantage, it could not be regarded as a transaction within the scope of a normal trade of share dealing. In this context, the following extract from the speech delivered by Lord Morris of Borth-y-Gest lays down an important principle:

> It is manifest that some transactions may be so affected or inspired by fiscal considerations that the shape and character of the transaction is no longer that of a trading transaction. The result will be, not that a trading transaction with unusual features is revealed, but that there is an arrangement or scheme which cannot fairly be regarded as being a transaction in the trade of dealing in shares.

It is relevant to also note that in the same decision, referring to the speech of Lord Morris of Borth-y-Gest in *Griffiths v. J.P. Harrison (Watford) Ltd.*, Viscount Dilhorne reiterated that a trading transaction does not cease to be such merely because it is undertaken by the taxpayer with the expectation of a fiscal advantage; if a transaction is established to be a trading transaction, it does not lose its character as a consequence of the fiscal advantage.

### 5.2.2.4. The limits of the Ramsay principle (*MacNiven (Inspector of Taxes) v. Westmoreland Investments Ltd*)

*Westmoreland* is one of the crucial decisions concerning the issue of tax avoidance in the United Kingdom, as it stipulates a new angle narrowing
down the Ramsay principle. 205 In this decision, Lord Hoffmann, while explaining the Ramsay principle, stressed that:

- in Ramsay, Lord Wilberforce was interpreting the words "disposal" and "loss" as commercial concepts. Since the said concepts were not necessarily confined to the categories of legalistic analysis, and since analysing the transaction in a strict legalistic fashion (and thereby treating each step in the transaction as autonomous and independent) would not have been determinative, he was applying the commercial meanings to the said statutory words; accordingly, Lord Wilberforce was contrasting between legalistic or arithmetical realities on the one hand and commercial realities on the other;

- it is necessary to construe the statutory language and ascertain whether it refers to a concept that Parliament intended to be given a commercial meaning capable of transcending the juristic individuality of its component parts. However, there are many terms in tax legislation that cannot be construed in this manner. Such terms refer to purely legal concepts that have no broader commercial meaning. In such cases, the Ramsay principle would have no application, and it would be irrelevant whether or not the transaction was undertaken with a business purpose;

- even if a statutory expression refers to a business or economic concept, one cannot disregard a transaction that comes within the statutory language, construed in the correct commercial sense, simply on the ground that it was entered into solely for tax reasons.

It is also important to note the following observation by Lord Hutton in his speech:

I consider that an essential element of a transaction to which the Ramsay principle is applicable is that it should be artificial. The requirement that there must be artificiality and the importance of distinguishing between the real world and the world of make-belief, between a real gain (or loss) and a contrived and unrealistic gain (or loss) have been stressed in a number of judgments of the House where the application of the Ramsay principle has been considered.

205. For a discussion on this case, also see Ballard, Richard, and Davison, Paul, "Form and Substance in Tax Law" (Chapter for the United Kingdom, paragraph 3.1), Cahiers de droit fiscal international, Volume LXXXVIIa, IFA 2002 Congress, Oslo.
5.2.3. Germany and the Netherlands

In Germany, Sec. 42 of the General Tax Law (Abgabenordnung, AO) contains the general anti-avoidance rule. However, Sec. 42 AO is not applicable in the case of transactions that have at least some economic substance, even if such transactions are tax advantaged.\(^\text{206}\)

In the Netherlands, Art. 31 of the General Taxes Act contains the general anti-avoidance provision (richtige heffing), which may be applied only with the authorization of the State Secretary of Finance. However, since 1 August 1987, no such authorization has been granted, and rather than resorting to the said Art. 31, tax avoidance is countered by resorting to the fraus legis principle developed by the Supreme Court.\(^\text{207}\)

The principle of fraus legis may be applicable in situations where a taxpayer undertakes a transaction exclusively or predominantly with the objective of obtaining a tax advantage that is in conflict with the legislative intent. In other words, for the principle of fraus legis to apply, the transaction must cumulatively satisfy the following two prerequisites:\(^\text{208}\)

(i) existence of motive to reduce tax; and
(ii) a conflict between the tax consequences of the transaction and the legislative intent.

In situations where fraus legis is applicable, a transaction may be recharacterized with a view to apply the tax treatment in accordance with the legislative intent and the economic substance of the transaction.

The principle of fraus legis does not apply to transactions in which the taxpayer primarily has a commercial motive. Accordingly, respectability of a transaction hinges on the taxpayer’s ability to demonstrate the commercial motive or economic substance, primary importance, underlying the transaction.

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206. See International Bureau of Fiscal Documentation, *Guides to European Taxation, European Taxation Database* (German Chapter, paragraph 13.1.).
207. For a discussion on this case, also see IJzerman, Robert, “Form and Substance in Tax Law (Chapter for the Netherlands, paragraph 3.1), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.
208. On application of the fraus legis principle under the Dutch tax law, see IJzerman, Robert, “Form and Substance in Tax Law” (Chapter for the Netherlands, paragraph 4.1), *Cahiers de droit fiscal international*, Volume LXXXVIIa, IFA 2002 Congress, Oslo.
5.3. Legal systems: impact on tax-driven cross-border leasing transactions

Before dealing with the specific types of tax-driven leasing transactions, we may briefly consider the impact that a legal system may have on tax-driven cross-border leasing transactions. For this purpose, a legal system is viewed, in a rather limited context, in respect of the approach followed in a jurisdiction for application of the provisions of a tax law to a given transaction. In this respect, a legal system may be either more inclined towards “formal reasoning” or towards “substantive reasoning”. For brevity, a legal system that is more inclined towards formal reasoning is hereafter referred as “formalistc legal system”, and a legal system that is more inclined towards substantive reasoning is referred as “substantive legal system”.

In a formalistic legal system, a transaction would have tax consequences in accordance with its legal form (rather than its economic substance), unless such a result is negated by the general or specific anti-avoidance rules. The United Kingdom could be cited as an example of such legal system. On the other hand, in a substantive legal system, the tax consequences of a transaction are likely to be determined on the basis of the economic substance (rather than the legal form) of the transaction. The United States, Germany and the Netherlands could be cited as examples of substantive legal systems.

The differing tax impact due to dissimilarities in the two types of legal system could be illustrated by considering a hypothetical finance lease transaction. In the case of a formalistic legal system, a finance lease would be respected as a lease transaction on the basis of the contract’s legal effects (i.e. the legal ownership in the leased asset continuing to vest with the lessor). Accordingly, in such a legal system, the lessor would be eligible to claim tax depreciation in respect of the leased asset, and the lessee would be eligible to claim the revenue deductions in respect of the lease rentals. On the other hand, in a substantive legal system, a finance lease transaction may be recharacterized as a transaction for sale and purchase of the asset, so that the lessor would not be eligible to claim tax depreciation in respect of the leased asset, as he would not be regarded as the “real” owner of the asset. But, as a corollary, in this kind of legal system, only the finance income component out of the gross lease rentals would be liable for taxation, unlike the gross lease rentals being liable to tax in a formalistic legal system.
It is submitted that a leasing transaction is granted a rather rigid tax treatment in a formalistic legal system as compared to a substantive legal system. While it may be possible to argue that a formalistic legal system affords a greater degree of certainty as regards the tax treatment of lease transactions, it is also arguable that in such legal system, a taxpayer may be in an advantageous position to manoeuvre the transaction to his benefit by moulding the transaction into a legal form that would yield the desired tax consequences, as long as the transaction is not negated by a specific anti-avoidance provision or general anti-avoidance principles.\(^{209}\) For that reason, it is submitted that a taxpayer operating in a formalistic legal system may more often (as compared to a taxpayer operating in a substantive legal system) be in a position to obtain tax consequences that may be inconsistent with the true economic substance of the transaction. On the other hand, in a substantive legal system, at least in a domestic leasing situation, it may be comparatively difficult (though not always impossible) for a taxpayer to secure a tax consequence different from the transaction’s true economic substance, as the mere legal form of the transaction would not be adequate to steer the tax consequences to his benefit. Accordingly it is submitted that, at least in respect of the tax-driven leasing transactions based on exploitation of the transaction characterization rules of a tax law (e.g. sale-and-leaseback transactions), a formalistic legal system is more susceptible to “abuse”\(^ {210}\) as compared to a substantive legal culture. For that reason, it is also submitted that the tax authorities and courts in a formalistic legal system are far more dependent on the anti-avoidance rules (general as well as specific) to counter the aggressively tax-driven leasing transactions as compared to their counterparts in a substantive legal system.\(^ {211}\) It is further submitted that since the specific anti-avoidance provisions may not be pre-

\(^{209}\) For instance, a lessor could secure tax depreciation by retaining the legal ownership in the leased asset with him.

\(^{210}\) Here, the word “abuse” is not used in a technical sense since, from a strict legalistic point of view, a transaction that is not negated by a anti-avoidance rules may not be regarded as abusive.

\(^{211}\) For clarity, it may be appropriate to note that this proposition does not imply that the tax authorities and courts in the substantive legal system would never be required to resort to the anti-avoidance rules. It is discernible that even in a substantive legal system, it may be possible for some taxpayers to undertake certain aggressively tax-driven transactions (e.g. like-kind exchange structures discussed later in this chapter) in a manner that may escape the substantive attributes of a tax system, unless negated by specific anti-avoidance provisions. However, it would be appropriate to stress that in a formalistic legal system, taxpayers appear to have greater possibilities of effectively carrying out aggressively tax-driven leasing transactions compared to their counterparts operating in a substantive legal system, since the legal form (rather than the economic substance) would play a greater role in determining the tax consequences in a formalistic legal system.
emptive enough to check an aggressive tax-driven leasing transaction, for countering "innovative" transactions, the tax authorities and courts would be compelled to rely heavily on the general anti-avoidance principles as compared to the specific anti-avoidance provisions in a tax law. But, ironically, it may be often possible for a taxpayer to successfully shield the transaction against the general anti-avoidance principles by suitably infusing a commercial or economic reason into the transaction, since normally, as discussed in 5.2., the general anti-avoidance principles do not disturb a transaction embodying a valid economic substance or commercial reason.

Unlike a domestic lease transaction that is influenced by a single legal system, a cross-border leasing transaction is influenced by two or more legal systems on account of the cross-border element in the transaction. Accordingly, the influence of legal systems on cross-border leasing transactions could be more complex as compared to the domestic lease transactions; and at the same time the parties to the transactions may have greater possibilities of deriving tax benefits from a tax-driven lease. In a cross-border lease where one jurisdictions adopts formalistic legal system and the other jurisdiction adopts substantive legal system, it may be possible for the lessor and the lessee to suitably formulate the transaction to exploit the features of both the system to their advantage. A double-dip lease could be regarded as a classic example in this respect, where the lease is designed in such a manner that both the lessor and the lessee would be regarded owners of the leased asset in their respective legal systems.

It is relevant to note that for the taxpayers to be able to exploit the differences between the two legal systems, it is not necessary that one legal system be formalistic and the other legal system substantive. It may be possible for the taxpayers to derive an advantage even where both the legal systems are substantive, but due to the differences in the criteria for attributing the economic ownership, the lessee and the lessor both may be regarded as owning the leased asset in their respective jurisdictions. However, it is submitted that where both the legal systems are formalistic, it would not be possible for the lessor and the lessee to simultaneously de-

-- 212 It could be argued that once a particular type of aggressively tax-driven leasing transaction is squarely covered by a specific anti-avoidance provision, it ceases to exist as an "insoluble" problem for the tax authorities. Also, if a particular type of leasing transaction is negated by a specific anti-avoidance provision of the relevant tax law, the legal system (whether formalistic or substantive) would not make a difference since the transaction would be in any case governed by the specific provision irrespective of the jurisdiction following the formalistic or substantive legal system.
rive such an advantage since only one of the two parties (generally the lessor) would be regarded as the legal owner of the leased asset.

5.4. Tax-driven leasing transaction structures

5.4.1. Sale and leaseback

5.4.1.1. Nature of the transaction

Sale and leaseback is one of the primitive leasing techniques whereby the owner of an asset sells the asset, and the buyer leases back the same to the erstwhile owner. A sale-and-leaseback transaction may have been entered into (from the perspective of the original owner/lessee of the asset) either for commercial reasons, or for the sole purpose of obtaining a tax advantage.\(^{213}\) It is submitted that, just as a lease transaction *per se* does not amount to an abusive transaction, not every sale-and-leaseback transaction should be viewed as an abusive transaction. For instance, an enterprise may enter into a sale-and-leaseback transaction to augment its working capital by relieving investment in fixed assets. Such a transaction may be entered into by the original owner/lessee of the asset for sound business reasons, though it may also give rise to a tax advantage.

It is possible that a sale-and-leaseback transaction may involve change of only legal ownership, while the economic ownership of the asset may vest in the same person (the original owner/lessee) prior to as well as subsequent to the transaction. It is submitted that the tax-motivated sale-and-leaseback transactions can be more effectively resorted to in the formalistic legal systems granting depreciation allowance on the basis of mere legal ownership of the asset, as compared to the substantive legal systems requiring economic ownership for eligibility of tax depreciation in respect of an asset, since generally the original owner/lessee would continue to retain the economic ownership over the leased asset. As a result, it appears that a tax system allowing depreciation on the basis of the economic ownership (rather than the legal ownership) possesses an inherent check against the tax-motivated sale-and-leaseback transactions. That seems to be the reason why specific anti-avoidance provisions to counter certain types of sale-and-leaseback transactions are found in the tax laws in the countries (for in-

5.4.1.2. The US: Court of Appeals decision in *Sun Oil Co. v. Commissioner of Internal Revenue*214

In this case, the taxpayer entered into an agreement with a tax-exempt trust for sale of a large number of service stations owned by the taxpayer. At the same time, the taxpayer entered into a leaseback agreement with a primary lease term of 25 years with an option to renew the lease by a further 65 years. Based on the terms of the arrangement between the taxpayer and the tax-exempt trust, the Court of Appeals ruled that the transaction was in the nature of a financing arrangement rather than a lease. However, it is relevant to note that the tax authorities challenged the transaction on the basis of characterization principles rather than any anti-avoidance provision, and the Court reached its conclusion on the same basis.215 This supports the view, expressed at 5.3., that a tax system allowing depreciation on the basis of the economic ownership (rather than the legal ownership) possesses an inherent check against the tax-motivated sale-and-leaseback transactions.

5.4.1.3. United Kingdom

5.4.1.3.1. *Restrictive provision under the Capital Allowances Act 2001*

Sale and finance leaseback was one of the common forms of lease transactions observed in the United Kingdom in the past. However, the tax advantages of sale-and-finance-leaseback transactions are now reduced due to introduction of the capital allowance restrictions discussed below.

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214. 562 F.2d 258 (US Court of Appeals for the third circuit).
With effect from 2 July 1997, in the case of sale and finance leaseback of plant or machinery, the acquisition value for the seller is restricted to the lower of the following:

- the amount of capital expenditure on plant or machinery originally incurred by the seller;
- sale price of plant or machinery,
- market value of plant or machinery; and
- the notional written-down value incurred by the seller or a person connected with the seller.

It is relevant to note that this restriction does not altogether eliminate the capital allowance entitlement of the lessor, but only casts a limitation on such an entitlement. Also, the above-stated provision applies only to cases of sale and finance leaseback, but not to sale and operating leaseback. For the purposes of this restriction, a lease is regarded as “finance lease” if it amounts to finance lease under the accounting principles. According to SSAP 21, where a lease transaction has the effect of a substantial transfer of the risks and rewards of ownership in the leased asset from the lessor to the lessee, the transaction is regarded as a “finance lease”. Risks and rewards are regarded as substantially transferred if at the inception of a lease the present value of the minimum lease payments, including any initial payment, constitutes a substantial portion (at least 90% or more) of the fair value of the leased asset. Thus, a sale-and-leaseback transaction under which the seller/lessee commits to pay to the lessor up to 89.99% of the fair value of the asset in the form of lease rentals and initial payment does not amount to finance lease; and in such cases the above-mentioned restriction would not apply. Depending on the nature of the asset, there could be cases where the lessor could reasonably expect to more than recoup the difference between the fair value of the asset at the inception of the lease and the payments receivable from the lessee, by selling the asset at the end of the

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217. For this purpose, the “notional written-down value” means the tax written-down value that 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.

218. SSAP 21, paragraph 15.
lease term. Thus, the above-mentioned restriction may not always frustrate a sale-and-leaseback transaction.

As per another restrictive provision under the UK Capital Allowances Act 2001, capital allowances are altogether denied to the lessor in the case of a sale and finance leaseback of plant or machinery, if as a part of the lease arrangement more than 50% of the risk of non-compliance by the lessee is removed (for instance, removal of such risk by way of a defeasance arrangement or a bank guarantee).\textsuperscript{219}

5.4.1.3.2. \textit{UK Court of Appeals decision in BMBF case}

It is relevant to note that recently, in \textit{Barclays Mercantile Business Finance Ltd. v. Mawson (Inspector of Taxes)},\textsuperscript{220} the Court of Appeals respected a sale-and-leaseback transaction. The said case is discussed at 5.4.13.2.

5.4.1.4. Netherlands: “technolease” cases

Though tax law in the Netherlands does not contain anti-avoidance provisions to counter sale-and-leaseback transactions, it is relevant to take note of two “technolease” transactions involving the sale and leaseback of intangible properties. Although leasing of intangible properties is beyond the scope of this study, as the issue involved in the “technolease” transactions is also relevant for leasing of tangible assets, the same is briefly pointed out here.

In one of the “technolease” transactions, a leading Dutch multinational company (“the company”) sold its know-how to a Dutch bank for about NLG 2.8 billion, of which the bank immediately paid NLG 600 million to the company. At the same time, the bank leased back the know-how to the company for a period of ten years to ensure that the company could continue using the know-how for its business purposes. As a consideration for the leaseback, the company agreed to pay to the bank an annual royalty of NLG 140 million and share with the bank 50% of the proceeds from licences based on the know-how. In another “technolease” transaction, a Dutch aircraft manufacturer sold its patent rights in respect of core technologies to a bank and leased them back.

\textsuperscript{219} See discussion at 3.5.2.7.
\textsuperscript{220} [2003] STC 66.
On 26 August 1994, the Dutch State Secretary of Finance issued a decree clarifying that for obtaining a tax benefit from a sale-and-leaseback transaction, the lessor must be the economic owner of the asset. The intent underlying the said decree could be viewed as to frustrate transactions similar to the above-mentioned “technolease” cases, since companies are expected to be averse to parting with the economic ownership of critical intangible assets such as core technologies. However, it is submitted that since, in any case, Dutch tax law provides for depreciation on the basis of economic ownership of the asset, the said decree may be regarded as providing mere clarification rather than providing an anti-avoidance measure to counter sale-and-leaseback transactions. Even in the absence of the decree, the lessor could qualify for tax benefits only if he was the economic owner of the asset, which once again demonstrates the proposition advanced in 5.3. that, as compared to a formalistic legal system, it is difficult for a taxpayer operating in a substantive legal system to derive a tax advantage from a leasing transaction by virtue of mere legal form of the transaction.

5.4.2. Chain-lease structure

5.4.2.1. Nature of the transaction

It appears that with a view to circumvent the UK capital allowance restrictions in respect of overseas leasing, some finance lessors have attempted chain-lease transactions. A chain-lease transaction may typically involve a long-term lease (headlease) to a UK resident sublessor and medium-term (less than 13 years) sublease to non-resident end user lessees. Recently, one such transaction was examined by the Chancery Division of the High Court in *BMBF (No. 24) Ltd v. Inland Revenue Commissioners*.221

5.4.2.2. *BMBF (No. 24) v. Inland Revenue Commissioners*

5.4.2.2.1. Relevant facts

In this case, Caterpillar Inc. ("CI"), a large US manufacturer of earth-moving, mining, construction and agricultural equipment, sought to raise fi-
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nance by exploiting the UK capital allowance\(^{222}\) regime.\(^{223}\) For this purpose, CI undertook a sale-and-leaseback transaction (through its wholly owned UK-based subsidiary). The relevant facts about the transaction were as follows:

- On 14 December 1995, CI sold certain equipment situated and used in its factories in the United States to its wholly owned subsidiary called Caterpillar International Leasing LLC (“CIL”), which was a resident in the United Kingdom.\(^{224}\) The said equipment was capable of being removed from the factories of CI.

- On 18 December 1995, BMBF (No. 24) (a UK company, hereinafter referred as “the lessor”) agreed to purchase the said equipment from CIL for GBP 165 million, and it paid the said purchase price.

- On 18 December 1995, the lessor leased back (hereinafter referred as “headlease”) the equipment to CIL for a term of 30 years and 19 days. The headlease was a standard finance lease, with provisions for rentals escalating throughout the duration of the lease term.

- Also on 18 December 1995, with the consent of the lessor, CIL subleased the equipment to CI for 11 years. The sublease was a standard operating lease with rentals evenly spread out over the lease term.

- Also on 18 December 1995, the lessor stated in a letter to CIL that CIL could enter into further subleases (beyond the original sublease for 11 years) with the prior written consent of the lessor, and the lessor affirmed in the said letter that such consent would not be unreasonably withheld if certain specified conditions were satisfied. One such condition was that the further sublease (beyond the original 11-year sublease) must not prejudice the lessor’s right to claim the capital allowances.

\(^{222}\) Referred to as “Written Down Allowances” (WDA) in the decision.
\(^{223}\) Etherton J. noted in his judgement that the structure of the transaction, involving sale and leaseback of the equipment and the (anticipated) availability of capital allowances was designed, *inter alia*, to provide CI with cheaper finance than, for example, an ordinary loan.
\(^{224}\) CIL was incorporated in Delaware on 31 October 1995 as a limited liability company. It registered in the United Kingdom as an overseas company, and was resident in the United Kingdom for tax purposes.
5.4.2.2.2. Relevant statutory provisions

Sec. 42 of the then applicable Capital Allowances Act 1990 reduced the capital allowance entitlement of a lessor to 10% (instead of the ordinary rate of 25%) in the case of machinery or plant that was used for the purpose of being leased to a person not resident in the United Kingdom. The capital allowance entitlement was altogether denied in the cases to which Sec. 42(3) applied. As the entire decision (running into over 80 pages) is based on interpretation of the language of the said Sec. 42, it is essential to reproduce Sec. 42 as starting point of the analysis.

Sec. 42 of the Capital Allowances Act 1990 provided as follows:

Assets leased outside the United Kingdom

(1) This section has effect with respect to expenditure on the provision of machinery or plant for leasing where the machinery or plant is at any time in the requisite period used for the purpose of being leased to a person who –
(a) is not resident in the United Kingdom, and
(b) does not use the machinery or plant exclusively for earning such profits or gains as are chargeable to tax (whether as profits or gains arising from a trade carried on in the United Kingdom or by virtue of section 830(4) of the principal Act,
and where the leasing is neither short-term leasing nor the leasing of a ship, aircraft or transport container which is used for a qualifying purpose by virtue of section 39(6) to (9).

(2) In their application to expenditure falling within subsection (1) above, sections 24, 25 and 26 ... shall have effect, subject to subsection (3) below, as if the reference in section 24(2) 25 per cent were a reference to 10 per cent.

(3) No balancing allowances or writing-down allowances shall be available in respect of expenditure falling within subsection (1) above if the circumstances are such that the machinery or plant in question is used otherwise than for a qualifying purpose and –
(a) there is a period of more than one year between the dates on which any two consecutive payments become due under the lease; or
(b) any payments other than periodical payments are due under the lease or under any agreement which might reasonably be construed as being collateral to the lease; or
(c) disregarding variation made under the terms of the lease which are attributable to –
   (i) changes in the rate of corporation tax or income tax; or
   (ii) changes in the rate of capital allowances; or
(iii) changes in any rate of interest where the changes are linked to changes in the rate of interest applicable to inter-bank loans; or
(iv) changes in the premiums charged for insurance of any description by a person who is not connected with the lessor or the lessee, any of the payments due under the lease or under any such agreement as is referred to in paragraph (b) above, expressed as monthly amounts over the period for which that payment is due, is not the same as any other such payment expressed in the same way; or
(d) either the lease is expressed to be for a period which exceeds 13 years or there is, in the lease or in a separate agreement, provision for extending or renewing the lease or for the grant of a new lease so that, by virtue of that provision, the machinery or plant could be leased for a period which exceeds 13 years; or
(e) at any time the lessor or a person connected with him will, or may in certain circumstances, become entitled to receive from the lessee or any other person a payment, other than a payment of insurance money, which is of an amount determined before the expiry of the lease and which is referable to a value of the machinery or plant at or after that expiry (whether or not the payment relates to a disposal of the machinery or plant).

5.4.2.2.3. Relevant issues before the High Court

The following issue dealt with by the High Court is relevant for the purpose of this research:

Whether the "lease" referred to in Sec. 42(3) is the headlease or the sublease. If such lease was the sublease, then Sec. 42(3) would not affect the lessor’s entitlement to capital allowance as the sublease did not possess any features referred to in Sec. 42(3)(a) to (e). Conversely, if Sec. 42(3) applied to the headlease, then the lessor would not be entitled to capital allowance on the leased equipment, as the headlease contained the conditions (e.g. lease term exceeding 13 years) referred to in Sec. 42(a) to (e).

5.4.2.2.4. Decision by the High Court on applicability of Sec. 42(3) to headlease or sublease

The lessor argued before the High Court that the lease referred to in Sec. 42(3) was the lease to the non-resident specified in Sec. 42(1), i.e. the sub-

225. It is relevant to note that in the presently applicable Capital Allowances Act 2001, as per Sec. 105(1)(b), a reference to a lease includes a sublease. As a result, it is submitted that this issue involving interpretation of the relevant provisions of the Capital Allowances Act 1990, would no longer arise under the Capital Allowances Act 2001.
lease in the instant case. On the other hand, the Revenue contended that once the asset was used for the purpose of providing a lease to a non-resident specified in Sec. 42(1), Sec. 42(3) applied to the lease to the owner of the asset, i.e. the headlease, irrespective of whether the lessee under the headlease was a non-resident.

As a starting point for analysing the issue, the Court looked at the legislative purpose underlying Sec. 42(3). The Court noted that the normal 25% rate of capital allowance was considerably in excess of commercial rates of depreciation of machinery or plant, and any unused capital allowance could be surrendered to other members of the group of which the trade of the lessor formed a part. The Court further stated that if, in the case of a finance lease, all the parties were resident in the United Kingdom, then the mismatch between the generous 25% rate of capital allowances and the lower rate of commercial depreciation and rentals would not be of any great practical significance in terms of tax collection, as any commercial advantage on account of low rentals would result in higher profits taxable in the United Kingdom.

The counsel for the lessor argued that the purpose of Sec. 42 was to target leases to non-residents. In support of the said argument, the counsel sought to rely on the following statement by the finance minister, made in the committee in the House of Commons in relation to the then proposed draft clause for reduction of capital allowances from 25% to 10% where the machinery or plant is used for the purpose of being leased to a non-resident:

I have already told the Committee why changes are needed in the capital allowances for assets leased abroad and the thinking behind the 10 per cent., but there is one aspect of the new arrangements that we shall want to come back to on Report if they are to be effective preventing further exploitation of capital allowances for the benefit of firms abroad. The 10 per cent allowance broadly allows the lessor to write off his capital outlay over a period of 14 or 15 years. In the normal case this is a reasonable provision without being unduly generous at the taxpayer's expense, but it is already clear that schemes are being developed to arrange the terms of foreign leases in such a way that they continue to incorporate a significant element of tax subsidy. Those schemes appear to rely on artificially skewing the profile of the rental payments by, for example, rear-end loading the capital repayments or by contriving very long leases. In each case the result is the same. The 10 per cent allowance would still be over-

226. I.e. the finance lessor, the finance lessee and any sublessee.
227. Low rentals, as the lessor would pass on the benefit of capital allowance to the lessee by way of a reduction from the lease rentals.
generous. Those devices are being openly discussed. If we took no action they could frustrate the intention behind the clause in a significant number of cases. We do not mean to let that happen. We are therefore giving thought to how best to deal with this matter, but it has not been possible in the time available to prepare firm proposals to put before the committee. We shall therefore wish to return to the subject on Report and we shall ask the House to provide that the amendment that we shall propose on Report should be effective from today.

However, the Court rejected the argument of the lessor’s counsel.

In the Court’s view, the purpose of Sec. 42 of the Capital Allowances Act 1990 was to curtail the commercial and tax advantages conferred by the ordinary 25% rate of capital allowances, where the plant or machinery was leased to a non-resident; that curtailment was intended to be achieved by matching (a) capital allowances entitlement to the finance lessor, and (b) the advantage achieved by the finance lessee in the form of lower rentals taxable in the United Kingdom. Thus, in the Court’s view, the purpose behind curtailment of the rate of capital allowances was to achieve a neutrality by netting-off capital allowances and rent, which was possible only if such process of netting-off was carried out between the finance lessor and the finance lessee i.e. at the level of the headlease rather than the sublease. Accordingly, the Court held that Sec. 42(3) applied to the headlease rather than the sublease. As a consequence, since the headlease was for a term in excess of 13 years, it was hit by Sec. 43(3)(d), and the lessor was not entitled to any capital allowance in respect of the leased equipment.

It is relevant to note that the Court expressed that there were severe deficiencies in the drafting of Sec. 42. However, in spite of such an acknowledgment, the Court adopted the textual approach of interpretation and analysed the language of the said section in a hair-splitting manner. For instance, at paragraph 85 it is stated:

I see nothing in the grammar or language of the opening words in Sec. 42(3) to indicate that the phrase “the machinery or plant in question is used otherwise than for a qualifying purpose” is being used otherwise than to refer to the current use of the machinery or plant. Neither grammatically, nor in terms of the language used, is there any obvious indication that the phrase is referring to, and only to, use of the machinery or plant under the lease to the non-resident.

228. Lower rentals on account of capital allowance benefit being passed on by the lessor to the lessee.
229. Paragraph 72 of the decision.
5.4.2.2.5. Critical remarks on the High Court decision

It is submitted that, contrary to the view expressed by the High Court, the legislative purpose behind Sec. 42 appears to prevent non-resident lessees from deriving a benefit at the expense of the UK exchequer, rather than to achieve a neutrality by netting-off capital allowances and the lease rentals. If the legislative purpose behind Sec. 42 was to match a finance lessor’s capital allowance entitlement with taxability of the advantage obtained by the finance lessee from lower rentals, then capital allowances would have been disallowable in the case of all overseas leases, rather than only leases meeting conditions of Sec. 42(3), since any advantage obtained by the overseas lessee would not be taxable in the United Kingdom in any case irrespective of the duration of the lease term, or lease rental payments evenly spread over the lease term. Also, if the legislative intention was to match the capital allowance entitlement of the finance lessor with the taxability of the income of the finance lessee in the United Kingdom, then capital allowances would have been disallowable even in the case of finance leases to tax-exempt entities resident in the United Kingdom.

5.4.3. Double-dip leasing

5.4.3.1. Nature of the transaction

The International Bureau of Fiscal Documentation, in its *International Tax Glossary*, defines “double-dip leasing” as:

...the possibility of obtaining double advantages or benefits in the form of depreciation deductions, investment credits, etc. because of differences in various countries’ tax rules on leasing. Typically, a double dip is obtained where the lessor is resident in a country which regards the lessor as the owner of the leased asset, and the lessee is resident in a country which regards the lessee as owner if, in substance, the lease transfers the risk and benefits of ownership. In such circumstances it may be possible for both the lessor and the lessee to obtain depreciation deductions.230

As a typical double-dip transaction is designed to leverage on the differences in the criteria (legal v. economic ownership) for eligibility for tax de-

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Depreciation under the tax laws of various countries, it appears that a double-dip lease transaction is possible only if at least one of the two jurisdictions grants depreciation allowance on the basis of economic ownership. As stated earlier, a tax-effective double-dip lease transaction may be possible even if both the jurisdictions grant depreciation allowance on the basis of economic ownership of the leased asset and both the lessor as well as the lessee may be regarded as economic owners of the leased asset in their respective jurisdiction due to the differences in the criteria for attributing economic ownership. In such cases, legal ownership is irrelevant. However, it seems that a double-dip lease transaction would not be possible where both the jurisdictions grant depreciation allowance on the basis of legal ownership of the leased asset, as both the lessor and the lessee cannot be simultaneously regarded legal owners in respect of the same leased asset.

5.4.3.2. Typical double-dip lease structure

A typical structure of a double-dip lease transaction may be somewhat like the following:

- A single equity investor or a group of equity investors from a jurisdiction granting depreciation allowance on the basis of legal ownership of the asset would form a lessor entity (transparent entity in case of group of investors) in the said jurisdiction, so that the equity investor(s) would be subject to a single level of taxation either on the basis of consolidated tax treatment of a group of companies or due to the transparent nature of the lessor entity, as the case may be. Similarly, the tax entitlements (such as the right to set off the tax loss from the leasing transaction) would flow to the equity investors.

232. I.e. the lessor’s jurisdiction and the lessee’s jurisdiction.
234. In practice, the equity investor(s) could be even from a foreign jurisdiction (i.e. other than the residence country of the lessor entity). However, for simplicity, it is assumed that the equity investor(s) and the lessor entity are from the same jurisdiction.
The lessor entity would purchase the asset with 20% own equity investment and 80% loan. The lessor entity would lease the asset to a lessee in another jurisdiction that grants tax depreciation on the basis of economic ownership in the leased asset.

The lease rentals would provide adequate cash flow to the lessor entity to service the loan.

The lessee may have a fixed price purchase option exercisable at the end of the lease term. The lease agreement may also provide a fixed-price put option for the lessor entity.

In some cases, the lease may be defeased, so that the lessee may make an upfront payment to a bank or a financial institution in respect of his lease rental obligations (as in Barclays Mercantile Business Finance Ltd. v. Mawson (Inspector of Taxes), discussed at 5.4.13.2.). The said payment may or may not include payment for the future purchase option. The amount of the said defeasance payment would be worked out on a “discounted cash flow” basis. The bank or the financial institution would assume obligation for making future payments to the lessor entity. Thus, the possibility of a default by the lessee is eliminated. The lessee may obtain a bank loan for funding the defeasance payment.

5.4.3.3. How does double-dip leasing provide a tax advantage?

As the lessee would have the fixed price purchase option at the end of the lease term, the lessee may succeed in upfront characterization of the transaction as purchase of the property rather than lease, in its residence state. Also, the fact that the lessee has fully defeased the future lease rental obligations may help the lessee in characterizing the transaction as purchase of the asset. As a result, the lessee may be entitled under the tax law of his jurisdiction to depreciate the leased asset. In that case, as a further advantage,

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235. In the case of a lessor resident in the United Kingdom, the lessee may not be granted a purchase option, since such an option may lead to recharacterization of the transaction as hire-purchase, in which case the lessee instead of the lessor may be eligible for capital allowances on the “leased” asset.

236. If the lessor is tax resident in the United Kingdom, the lease may not confer a purchase option to the lessee. However, the lessee may still be able to qualify as the economic owner of the leased asset in his jurisdiction on the basis of other features of the lease.
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payments by the lessee would not be viewed as “lease rentals” and hence may not be subject to withholding tax in the residence state of the lessee.

On the other hand, on the basis of the legal ownership in the asset, the lessor entity (or another “sister company” within the group of the lessor entity, or the equity investors in the lessor entity, as the case may be) may be able to deduct depreciation in respect of the leased property. During the early years of the lease term, especially if the lessor entity is allowed depreciation under the declining-balance method, the amount of depreciation allowance may substantially exceed the gross amount of taxable lease rentals, resulting in a tax loss; so that the transaction may facilitate tax deferral. The said tax loss may be set off against other taxable income of a sister company within the lessor entity’s group or by the equity investors, as the case may be.

5.4.3.4. Can double-dip lease, per se, be regarded as abusive?

It is submitted that, generally, a double-dip lease transaction must not be regarded as an abusive transaction, as long as it possesses attributes of a commercial transaction entered into by the parties for sound business reasons.

Under the tax laws of the jurisdictions examined for the purposes of this study, it is an established principle that as long as a transaction embodies a commercial purpose, a collateral motive of deriving a tax advantage is irrelevant; and the general anti-avoidance principles do not affect such a transaction.

In the United States, a double-dip lease transaction embodying genuine economic substance (besides tax advantages) could be expected to pass the necessary tests under the sham transaction doctrine (the double-dip lease not being a “fake” transaction) as well as the business purpose and the economic substance doctrines (on account of the business purpose embraced in the transaction); the step transaction doctrine should not be applicable in the absence of any interposed transactions, and the substance-over-form doctrine should not apply since in any case the transaction would be characterized (in the United States) in accordance with its economic substance.

In Germany, the anti-avoidance principles contained in Sec. 42 AO and, similarly, in the Netherlands the anti-avoidance principle fraus legis do not affect transactions possessing economic substance.
As regards the United Kingdom, it is submitted that the scope of application of the general anti-avoidance principles is even narrower, as the Ramsay principle does not apply to the transactions that are not regarded as a sham. Indeed, in the United Kingdom, it may be possible for a taxpayer to argue on the basis of the House of Lords decision in Westmoreland that even if a transaction is carried out for the sole purpose of deriving a tax advantage, it should not be affected by the Ramsay principle as long as the transaction is construed as a proper commercial transaction.

Accordingly, it is submitted that a double-dip lease transaction embodying economic substance should not be regarded as abusive, regardless of the tax advantages derived by the parties to the transaction.

5.4.4. Two-tier double-dip structures

5.4.4.1. Nature of transaction

A two-tier double-dip structure involves a cross-border lease and a cross-border sublease, and the transaction is designed in a manner such that the lessor, the sublessor as well as the lessee are regarded as owning the leased asset so that all of them qualify for tax depreciation in their respective jurisdictions. In essence, a two-tier double-dip structure is an expansion of a double-dip structure discussed at 5.4.3., and it is designed to leverage on the differences in the criteria (legal v. economic ownership) for granting tax depreciation under the tax laws of various countries. It is relevant to note that a transaction with a two-tier double-dip structure is possible only if at least two out of the three jurisdictions (i.e. the jurisdiction of the lessor, the sublessor and the lessee) grant depreciation allowances on the basis of economic ownership rather than the legal ownership of the leased asset.

5.4.4.2. Use of two-tier double-dip structures in Japan

“Two-tier double-dip structure” was practised in Japan for a short period in the late 1980s.237 Under this arrangement, in addition to the other features of the Japanese leveraged-lease structure, an offshore special-purpose vehicle (SPV) (owned by foreign equity investors) would be interposed between the Japanese lessor SPV and the lessee. The lessor SPV would

provide a headlease to the offshore SPV, and the offshore SPV would sublease the assets to the ultimate lessee. In Japan, the lessor SPV was entitled to tax depreciation on the leased asset. Based on the depreciation regulations in the jurisdiction of the offshore SPV, the offshore SPV was able to claim tax depreciation on the leased assets. The combined tax benefits obtained by the Japanese lessor SPV and the offshore SPV translated into significant pricing advantage for the lessee.

This structure, however, was short lived, as in 1990 the Japan Leasing Association decided to refrain from using the structures with the interposed offshore SPVs, to avoid a potential situation of the Japanese tax authorities viewing the structure as an abusive practice.\(^{238}\)

5.4.4.3. Can the two-tier double-dip leasing, per se, be regarded as abusive?

While it is not doubted that a two-tier double-dip lease could be viewed as a much more aggressive transaction as compared to a (single-level) double-dip lease transaction, its efficacy largely depends on the success of the intermediate entity (sublessor) in proving that it played a valid commercial role in the transaction.

For the purposes of this analysis, the following hypothetical transaction structure may be considered:

![Diagram](image)

It is submitted that the existence of the intermediate entity (Sublessor B) should not affect the transaction characterization in Country A and Country C, even if Sublessor B is disregarded and the transaction is assumed to be a single-level double-dip lease between Lessor A and Lessee C, as long as

the "reconstructed transaction" retains the characteristics necessary for Lessor A and Lessee C to qualify as the legal owner and the economic owner of the leased asset in their respective jurisdictions. Accordingly, as regards the transaction characterization, even if Sublessor B (and the intermediate transaction) is disregarded, the tax implications to Lessor A and Lessee C should not be worse than the implications if the transaction was a direct single-level double-dip lease between Lessor A and Lessee C. Derecognition of Sublessor B in Country C should not have any adverse withholding tax consequences, as long as Country C regards as a transaction a purchase-sale transaction governed by the "Business profits" article of the tax treaty, if any, between Country A and Country C. On the other hand, if the intermediate transaction undertaken by Sublessor B is recognized in Country B, then Sublessor B would be able to obtain a tax advantage in Country B, that would be for the benefit of all the parties to the two-tier double-dip transaction. Accordingly, it is submitted that the efficacy of a double-dip transaction hinges on the ability on the part of Sublessor B to successfully defend the intermediate transaction undertaken by it.

Sublessor B should be successful in defending its role in the two-tier double-dip lease, if it can demonstrate an economic substance in its acting as an intermediary. Although a mere profit motive may not constitute sufficient economic substance, any value-added role played by Sublessor B could amount to an acceptable economic substance. For instance, if Sublessor B bundles highly respected aircraft simulation software developed by itself with the hardware obtained by it on lease from Lessor A, and then leases the integrated hardware and the software to Lessee C, then the transaction undertaken by Sublessor B should be regarded as possessing valid economic substance. In such a case, it is submitted, the intermediate transaction performed by Sublessor B would not be in conflict with the general anti-avoidance principles under the tax laws of any of the four countries examined for the purposes of this research.

239. I.e. double-dip lease directly between Lessor A and Lessee C.
240. In this regard, it is submitted that since the original two-tier double-dip lease transaction was formulated in a manner such that the legal ownership and the economic ownership in the leased asset would have been attributable to Lessor A and Lessee C in Country A and Country C respectively, even if the intermediate transaction involving sublessor C was to be subsumed into the reconstructed single-level double-dip lease transaction between Lessor A and Lessee C, the original ownership attributes of Lessor A and Lessee C should not be affected.
241. Since normally a two-tier double-dip lease would be attempted to exploit the transaction characterization rules in the three jurisdictions involved (rather than to derive a benefit under the tax treaty network of the intermediate jurisdiction), the treaty shopping aspects are not considered in this analysis.
5.4.5. Leveraged leasing

5.4.5.1. Nature of transaction

The International Bureau of Fiscal Documentation, in its *International Tax Glossary*, defines “leveraged leasing” as:

Type of finance lease in which the lessor acquires property substantially with funds borrowed from an outside lender, i.e. a long-term creditor is involved in the transaction in addition to the lessor and the lessee. The creditor provides non-recourse financing, and the lessor’s liability for repayment of the borrowed funds is usually restricted to the value of the leased property. Because deductions such as interest, depreciation and capital allowances are high in the initial years of the lease, it is possible for substantial tax losses to be generated in the early years of the lease.242

Typically, a leveraged-lease transaction may be funded by way of 20-25% equity and 75-80% debt funding. Often, the debt funding is in the form of a non-recourse borrowing,243 unless the tax law of a jurisdiction renders the non-recourse borrowing disadvantageous (as in the case of the United States, as discussed hereafter). Such transactions are commonly referred to as “leveraged leasing”, since the borrowing leverages the lessor’s ability to lease assets valuing up to four to five times of his equity capital, and thus obtain four to five times the amount of depreciation allowance, as compared to the depreciation allowance that he would have been entitled to, had it leased the assets without resorting to borrowing. The non-recourse nature of the borrowing limits the lessor’s risk to the extent of its own equity investment in the lease, thus enabling the lessor to maximize the volume of leasing transactions and, as a consequence, obtain the maximum possible amount of depreciation allowances. Often, unless rendered ineffective by the tax law of the lessor’s jurisdiction, a leveraged-lease transaction may be designed with rear-loaded lease rental payments244 so that the transaction generates tax losses in the earlier years, which the lessor or other companies within the group could set off against his other taxable income.

244. I.e. the lessor would receive relatively small amounts from the lessee in the initial years and greater amounts in later years in the lease term.
5.4.5.2. Comparative analysis of the anti-deferral provisions (to counter the rear-loaded leases) under the US and the UK tax laws

As discussed at 4.2., IRC Sec. 467, along with the Final Sec. 467 Regulations, effectively nullifies the tax advantages of rear-loaded leveraged lease. In the United Kingdom, to a certain extent, the provisions of the Finance Act 1997, Schedule 12, Part 2 dilute the tax advantage of a rear-loaded lease transaction. However, it is submitted that, unlike IRC Sec. 467 combined with Final Sec. 467 Regulations, the said provisions of the UK Finance Act 1997 are not adequate to completely eliminate the tax advantage of a rear-loaded lease, for the following reasons:

In the United States, under the IRC, once a transaction is characterized as a “true lease”, it falls within the ambit of IRC Sec. 467, irrespective of whether such lease is viewed as a finance lease or an operating lease for accounting purposes. IRC Sec. 467 combined with the Final Sec. 467 Regulations, contains detailed rules, independent of the accounting principles. The said rules are based on the time value of money, and they embrace sophisticated methods for computation of present values, and provide for imputation of interest income in case of transactions involving deferred or increasing rents. Accordingly, IRC Sec. 467 is an effective obstacle against rear-loaded lease transactions.

Unlike IRC Sec. 467, the UK Finance Act 1997, Schedule 12, Part 2 relies on the accounting principles for neutralizing the tax advantage of a rear-loaded lease transaction. Under the UK Generally Accepted Accounting Principles (SSAP 21), in the case of a finance lease the aggregate gross lease rentals receivable by the lessor from the lessee over the lease term are split into (a) the principal amounts representing recovery of the cost of the leased asset (not treated as income), and (b) financing income representing interest or yield on the lessor’s investment in the leased asset (treated as income). However, the UK Finance Act 1997 does not take into account the difference in treatment of the finance lease rentals under the accounting principles vis-à-vis the principles under tax law. As a result, by virtue of the UK Finance Act 1997, Schedule 12, Part 2, recognition of income on an accrual basis is ensured only in respect of the part of the gross finance lease rentals corresponding to the financing/interest income, but the finance lessor still has the possibility of rear-loading the lease rentals with a view to obtain a tax advantage in respect of the part of the gross lease rentals cor-
responding to the cost of the leased asset. This could be demonstrated with the help of the following illustration:

**Hypothetical transaction**

Consider a finance lease transaction where the original cost of the leased asset is GBP 100 million. The lease arrangement is based on interest payments by the lessee to the lessor, at the end of every taxable year. The rate of interest is 10%, charged on the cost of the asset (the principal amount) remaining outstanding at the beginning of the taxable year. For the first six years during the ten-year lease term, the lessee pays only interest and does not pay any amount corresponding to the cost of the leased asset. During year 7 to year 10, the lessee makes payment in respect of the cost of the leased asset plus interest. As a result, the lease transaction involves the rear-loaded lease rentals. Accordingly, the Accountancy Rental Earnings (ARE) and Normal Rent (NR) would be as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Asset cost outstanding at beginning of the year</th>
<th>ARE (interest amount)</th>
<th>Repayment towards asset cost</th>
<th>NR (gross lease rentals)</th>
<th>Asset cost outstanding at the year-end</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>100</td>
<td>10</td>
<td>0</td>
<td>10</td>
<td>100</td>
</tr>
<tr>
<td>2</td>
<td>100</td>
<td>10</td>
<td>0</td>
<td>10</td>
<td>100</td>
</tr>
<tr>
<td>3</td>
<td>100</td>
<td>10</td>
<td>0</td>
<td>10</td>
<td>100</td>
</tr>
<tr>
<td>4</td>
<td>100</td>
<td>10</td>
<td>0</td>
<td>10</td>
<td>100</td>
</tr>
<tr>
<td>5</td>
<td>100</td>
<td>10</td>
<td>0</td>
<td>10</td>
<td>100</td>
</tr>
<tr>
<td>6</td>
<td>100</td>
<td>10</td>
<td>0</td>
<td>10</td>
<td>100</td>
</tr>
<tr>
<td>7</td>
<td>100</td>
<td>10</td>
<td>10</td>
<td>20</td>
<td>90</td>
</tr>
<tr>
<td>8</td>
<td>90</td>
<td>9</td>
<td>21</td>
<td>30</td>
<td>69</td>
</tr>
<tr>
<td>9</td>
<td>69</td>
<td>6.9</td>
<td>23.1</td>
<td>30</td>
<td>45.9</td>
</tr>
<tr>
<td>10</td>
<td>45.9</td>
<td>4.59</td>
<td>45.9</td>
<td>50.49</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>90.49</td>
<td>100</td>
<td>190.49</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

As it may be observed from the above, out of the aggregate gross lease rentals of GBP 190.49 million over the ten-year lease term, only GBP 90.49 million corresponding to the interest/finance income component is treated as ARE, whereas it is possible for the parties to the lease transaction to rear-load the lease rentals corresponding to the cost of the leased asset, i.e. GBP 100 million. Accordingly, while the UK Finance Act 1997 seeks to tax the finance leasing income on an accrual basis in accordance with the accounting principles, it does not bridge the gap on account of the difference in the basic concept of “income” under SSAP 21 (treating only finance income as income) and the tax law (treating the gross amount of finance lease rental
as taxable income). Accordingly, in spite of the anti-deferral provisions contained in the Finance Act 1997, Schedule 12, Part 2, it is possible for the lessors to defer the income recognition in respect of a substantial part of the gross lease rentals.

5.4.5.3. Use of non-recourse debt funding in leveraged leases: position in the United States and the United Kingdom

5.4.5.3.1. United States: “at risk” provisions of Sec. 465 of the IRC

IRC Sec. 465 provides “at risk” rules, as a result of which the loss incurred by a taxpayer from leasing activities is deductible only to the extent the taxpayer is at risk in respect of the leased asset. A taxpayer is regarded at risk in respect of a leased asset to the extent of the aggregate of the following:
- cost of the leased asset contributed by the taxpayer himself (i.e. own equity investment); and
- amounts borrowed for acquiring the asset, to the extent the taxpayer (i) is personally liable for the repayment of the borrowed amount, or (ii) has pledged an asset, other than the leased asset for acquisition of which the amount was borrowed.

Accordingly, if the lessor has obtained a non-recourse loan for financing asset acquisition, then any tax loss arising from the lease of such asset would be deductible only to the extent the cost of the asset is not financed by the non-recourse loan. It is relevant to note that IRC Sec. 465 restricts only the deduction of the loss; it does not impose any restriction in respect of depreciation allowance or deduction for interest payment on the non-recourse loan. Also, if the loss deduction is denied in a particular taxable year due to the operation of IRC Sec. 465, such loss is carried forward and treated as a deduction allocable to leasing activity in the succeeding year. Accordingly, the loss so carried forward is allowed as deduction in a taxable year when the taxpayer generates taxable leasing income that is adequate to absorb the said loss.

245. I.e. either an individual or a C Corporation.
246. Subject to IRC Sec. 465 provision in respect of a loss deduction in the succeeding year. Accordingly, if the result of the succeeding year is also a loss, then the loss deduction would again be subject to IRC Sec. 465.
Thus, IRC Sec. 465 effectively neutralizes the tax advantage of the leveraged lease involving non-recourse finance, as a lessor would be able to set off the loss (during early years in a lease term) from leasing transaction against his other taxable income only to the extent the leased asset is not financed by way of a non-recourse loan.

5.4.5.3.2. United Kingdom: House of Lords decision in Ensign Tankers case

Although the Ensign Tankers case did not involve a lease transaction, it is relevant for leveraged leasing as the case involved non-recourse debt funding.

Relevant facts

The relevant facts in the case were as follows:

Ensign was a UK tax resident company, and a member of a UK-based group of companies. In 1980, Ensign entered into a limited partnership arrangement with Victory Film Productions Ltd. (“Victory Productions”) and four other companies. The partnership was named “Victory Partnership” wherein Victory Productions was the general partner and Ensign and the other four companies were limited partners. The limited partners, including Ensign, contributed USD 3,250,000 to the initial capital of the partnership.

Victory Partnership undertook to make a full-length motion picture “Escape to Victory” (“the film”), the budgeted cost of which was USD 13 million. For this purpose, Victory Partnership entered into a loan arrangement with a US company Lorimar Productions Incorporated (“LPI”, the parent company of Victory Productions). The relevant terms of the said loan arrangement were as follows:

LPI agreed to lend to Victory partnership USD 9,750,000 needed for completing the film. This loan was termed as “production loan”. Also LPI

248. Victory Productions was a UK-incorporated company beneficially owned by a US company, Lorimar Productions Incorporated (“LPI”).
249. Out of the total capital contribution of USD 3,250,000, Ensign Tankers had contributed USD 2,375,800 (i.e. about 73% of the total capital contribution made by the limited partners).
agreed to lend to Victory Partnership any further amount required to complete the film. This second loan was termed as “completion loan”.

Both the loans were non-recourse loans, so that they were repayable exclusively out of the receipts of the film without recourse to Victory Partnership or its general or limited partners or their assets.

The net receipts of the film were divisible between Victory Partnership and LPI as follows:

<table>
<thead>
<tr>
<th>Stage</th>
<th>Percentage of net receipts from the film payable to</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>25% to Victory Partnership and 75% to LPI, until Victory Partnership recouped its investment of USD 3,250,000 in the film</td>
<td>at the end of Stage 1, Victory Partnership would have recovered its investment in the film, and LPI would have recovered the production loan of USD 9,750,000, but not interest/profit on the loan/investment.</td>
</tr>
<tr>
<td>2</td>
<td>100% to LPI until LPI recovered completion loan and interest on production loan and completion loan</td>
<td>at the end of Stage 2, LPI would have recovered the completion loan and interest on the two loans; however, Victory Partnership would not have received any profit on its investment in the film.</td>
</tr>
<tr>
<td>3</td>
<td>25% to Victory Partnership and 75% to Lorimar Distribution International Incorporated (LDII)</td>
<td>LDII was an associate company of LPI, to which Victory Partnership had granted exclusive license in perpetuity to distribute and exploit the film outside the United Kingdom; thus, in Stage 3, Victory Partnership and LPI (as a group, through LDII) would have shared profit from the film in the ratio of 25:75.</td>
</tr>
</tbody>
</table>

Relevant provisions under the then applicable UK tax law

Sec. 41(1) of the UK Finance Act 1971, that provided for first-year allowances in respect of capital expenditure on machinery or plant, incurred by a trader for the purposes of his trade, read as follows:
... where (a) a person carrying on a trade incurs capital expenditure on the provision of machinery or plant for the purposes of the trade, and (b) in consequence of his incurring the expenditure the machinery or plant belongs to him at some time during the chargeable period related to the incurring of the expenditure, there shall be made to him for that period an allowance (in this chapter referred to as “a first year allowance”) which shall be an amount determined in accordance with Section 42 ...

In 1980 (the relevant tax year), the master negative of a commercial film constituted “plant”, and the first-year allowance available under Sec. 42 was 100%.

As per Sec. 155 of the Income and Corporation Taxes Act 1970, the benefit of any first-year allowance obtained by Victory Partnership accrued to the limited partners in the proportions in which they respectively contributed to the capital of the partnership.

Dispute between Ensign Tankers and the UK tax authorities

Ensign Tankers, as one of the limited partners in Victory Partnership, took the view that Victory Partnership had incurred a capital expenditure of USD 14 million on the film and accordingly Victory partnership was entitled to the first-year allowance to the extent of USD 14 million.\(^{250}\)

On the other hand, inter alia, the UK tax authorities took the following positions:

1. the film transaction undertaken by Victory Partnership was entirely driven by fiscal considerations and therefore it could not be regarded as a commercial transaction.\(^{251}\) Therefore, the expenditure incurred by Victory Partnership was not for the purposes of a trade and, hence, did not generate any first-year allowance.\(^{252}\)

\(^{250}\) Accordingly, Ensign Tankers claimed that it was entitled to avail itself of the first-year allowance of about USD 10 million (i.e. about 73% of USD 14 million) – corresponding to Ensign Tankers’ share in the total capital contributed by the limited partners in Victory Partnership).

\(^{251}\) Besides this view, the tax authorities also contended that the film did not belong to Victory Partnership since, as soon as Victory Partnership acquired the film, it parted with the right to distribute and exploit the film in perpetuity, retaining only the “bare” master negative. Since this issue is not relevant for the purposes of the present study, the same is not dealt with in this study.

\(^{252}\) As a result, the tax authorities rejected Ensign Tankers’ claim for the first-year allowance relating to the film.
(2) in any case, Victory Partnership had incurred expenditure only to the extent of the cost of the film funded through its own capital i.e. USD 3,250,000.

**Decision of the Special Commissioners**

In the first appeal, the Special Commissioners viewed the limited partnership arrangement as a tax avoidance scheme, and opined that the transactions undertaken with fiscal motives as their paramount object did not amount to trading transactions and accordingly held that Victory Partnership was not engaged in trading activities. Accordingly, the Special Commissioners confirmed the view taken by the tax authorities that Victory Partnership did not generate any first-year allowance.

**Decision of the High Court**

In the second appeal, the High Court reversed the decision of the Special Commissioners. It opined that Victory Partnership was engaged in trade. The High Court opined that the fact that a borrower obtaining a non-recourse loan did not incur any personal liability to repay the loan to the lender was irrelevant for the purposes of Sec. 41 and that section was concerned with the taxpayer’s liability to expend an amount in the acquisition of plant, rather than the borrower’s liability to repay the loan (to the lender). Accordingly, the High Court held that Victory Partnership had generated the first-year allowance to the extent of USD 14 million.

Also, the High Court opined that as the transaction undertaken by Victory Partnership was neither a paper transaction without any commercial purpose nor a single transaction artificially broken into separate stages, the principles laid down by the House of Lords in *W.T. Ramsay Ltd. v. Inland Revenue Commissioners* and *Furniss v. Dawson* did not apply in the present case.

**Decision by the Court of Appeals**

Upon the tax authorities appealing against the High Court decision, the Court of Appeals remitted the matter to the Special Commissioners to re-ascertain the facts, by applying certain criteria provided by the Court of Appeals, whether Victory Partnership carried on a trade. Ensign Tankers ap-

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pealed against said decision of the Court of Appeals, and pleaded before the House of Lords to restore the decision of the High Court.

**Decision by the House of Lords**

The House of Lords held that Victory Partnership was engaged in a trade. However, on the issue of the amount of the first-year allowance, the House of Lords held that Victory Partnership had incurred only USD 3,250,000 and not USD 14 million. The House of Lords reached this conclusion on the basis of the following reasons explained in the decision:

- LPI was not entitled to recover from Victory Partnership or any other person any part of the monies expended by LPI on the film;
- the House of Lords confirmed (except for minor inaccuracies) the observations made by the High Court in its decision that, in purely financial terms, Victory Partnership was in effect a sleeping partner with a minority effect; it invested 25% of the cost of the film and took 25% equity participation, whereas LPI invested 75% of the cost of the film and took 75% equity participation;
- accordingly, based on the above-stated observations, the House of Lords found the transaction between Victory Partnership and LPI to be a joint venture rather than a loan.

The House of Lords held that the transaction involved a tax avoidance scheme, as the tax advantage (first-year allowance) sought to be derived by Ensign Tankers was inconsistent with the consequence of the transaction, i.e. real expenditure for acquiring the film.

The following remarks made by Lord Templeman in the decision appear to constitute the core-forming basis for reaching this conclusion:

... by reason of the non-recourse provision of the loan agreement, the loan was not repayable by Victory Partnership or any one else. A creditor who receives a participation in profits in addition to repayment of his loan is of course a creditor. But a creditor who receives a participation in profits instead of repayment of his “loan” is not a creditor. The language of the document in the latter case does not accurately describe the true legal effect of the transaction which is a capital investment by the “creditor” in return for a participation in profits.

Thus, the House of Lords recharacterized the non-recourse lending by LPI as equity participation, and held that Victory Partnership had incurred capital expenditure for acquiring the film only to the extent of USD 3,250,000, whereas the remaining cost of the film was incurred by LPI. It is interesting
to note, however, that the House of Lords rejected the submission made by the tax authorities that since the transaction involved a tax avoidance scheme, Victory Partnership should be altogether denied the first-year allowance. In this context, the following expression by Lord Templeman could be viewed as providing an important principle on the duty of the UK courts concerning the analysis of the true legal effect of a transaction:

The task of the courts is to construe documents and analyse facts and to ensure the taxpayer does not pay too little tax or too much tax but the amount of tax which is consistent with the true effect in law of the taxpayer’s activities. Neither the taxpayer nor the Revenue should be deprived of the fiscal consequences of the taxpayer’s activities properly analysed.

The House of Lords opined that Sec. 41 was not concerned with the purpose of the transaction, but it was concerned with the purpose of the expenditure; and though it was true that Victory Partnership only engaged in the film trade for the fiscal purpose of obtaining the first-year allowance, that did not alter the purpose of the expenditure. The House of Lords also confirmed that as the expenditure of USD 3,250,000 incurred by Victory Partnership was a real expenditure, the principles of Ramsay and subsequent authorities did not apply to the said expenditure. Accordingly, the House of Lords held that Victory Partnership had generated a first-year allowance to the extent of USD 3,250,000.

5.4.5.3.3. United Kingdom: implications of Ensign Tankers decision on leveraged leases involving non-recourse debt financing

Since, generally, leveraged leases involve non-recourse debt financing, the House of Lords decision in Ensign Tankers is important for the purposes of the present research. The said decision raises a critical issue as to whether, in the United Kingdom, every case of non-recourse debt financing is susceptible to recharacterization as equity participation by the “creditor”. If that is the position, then a UK lessor in a leveraged lease involving the non-recourse debt financing would be entitled to capital allowance only to the extent of the cost of the leased asset financed by the lessor through his own equity or through a debt other than non-recourse, as the cost of the leased asset financed through non-recourse debt may be viewed as expenditure “incurred” by the non-recourse “creditor” rather than the lessor. At the same time, since the capital allowances are available in the United Kingdom on the basis of the legal ownership of the asset, the non-recourse creditor would normally not be entitled to capital allowance in respect of the
Chapter 5 – Limits of tax-driven cross-border leasing transactions

said leased asset (even if he is tax resident in the United Kingdom), as he would not be legal owner of the asset.

However, upon a careful analysis of the House of Lords decision in *Ensign Tankers*, it is submitted that:

(i) not every case of non-recourse debt financing may warrant recharacterization as equity participation by the creditor;

(ii) *Ensign Tankers* does not lay down a general rule that every non-recourse debt must be recharacterized as equity participation; and

(iii) a particular transaction involving non-recourse financing may be recharacterized only if the relevant facts warrant such action (as done in *Ensign Tankers*), rather than an automatic process.

The above-stated propositions are based on the following reasoning:

– In *Ensign Tankers*, on the basis of the terms of arrangement between Victory Partnership and LPI, the House of Lords concluded that the legal effect of the transaction was a joint venture rather than a loan relationship. This was especially in view of the fact that LPI only shared with Victory Partnership the net receipts from the film, rather than recovering the amount of loans plus interest.

– While the non-recourse element capped the exposure of Victory partnership to its own investment in the film, i.e. USD 3,250,000, that alone, *per se*, was not adequate for recharacterization of the transaction as a joint venture. It appears that, rather, it was the revenue sharing mechanism (between Victory Partnership and LPI in the ratio of 25:75) that led the House of Lords to view the transaction as a joint venture instead of a loan relationship.

– It is submitted that the absence of a creditor’s recourse to the lessor and his other assets (other than the leased asset in question), *per se*, does not de-nature a genuine loan transaction. It is possible that a creditor may agree to limit his recourse only to the income from and value of the leased asset, which may amount to a shift of the credit risk\(^{255}\) and the “residual value risk”\(^{256}\) from the lessor to the creditor. However,

\(^{255}\) i.e. the risk of the lessee not fulfilling the lease rental obligations on account of insolvency or any other reason.

\(^{256}\) i.e. the risk that the future market value of the leased asset may fall below the expectation of the lessor/creditor, and the reduced future market value of the leased asset may not be adequate for repayment of the non-recourse debt owed by the lessor to the creditor.
probably, the creditor might have agreed for such “risk-shifting” in consideration for a higher rate of interest (compared to a normal interest rate in case of financing with full recourse to the lessor and his other assets). In such a case, the differential interest rate (i.e. the higher rate of interest in respect of a non-recourse loan as compared to a full-recourse loan) may be comparable to an “insurance premium” payable by the lessor for insuring his credit risk and residual value risk. Also, a shift of the credit risk from the lessor to the creditor may be analogous to certain types of securitization transactions. As regards the “residual value risk”, it is not difficult to find insurance companies specializing in insuring such risks on an arm’s length basis. The shift of the credit risk from the lessor to the non-recourse creditor may involve a risk no more than the risks involved in a commercial factoring or securitization transaction. Similarly, shift of the “residual market value risk” from the lessor to the non-recourse creditor may involve a risk no more than the risks involved in a commercial options contract. Thus, a non-recourse financing transaction could be based on genuine commercial arrangements. Especially, in cases where the creditor recovers from the lessor the principal amount plus interest at a specific rate (rather than sharing with the lessor the lease rentals and realization of proceeds from potential sale of the leased asset), the transaction should be viewed as a loan relationship rather than a joint venture between the lessor and the creditor.

Accordingly, it is submitted that the House of Lords decision in Ensign Tankers must not affect genuine non-recourse financing transactions (that may be truly commercial transactions rather than joint venture arrangements camouflaged in the form of financing transactions as the House of Lords found in Ensign Tankers), and such transactions would be distinguishable from the facts in the Ensign Tankers case.

For the above-stated reasons, it appears that in the case of genuine commercial transactions of non-recourse financing, a lessor must not be denied the advantage of capital allowance in the absence of “at risk” provisions similar to Sec. 465 of the US IRC.

The above view derives further strength from the following remarks made by Lord Goff in his concurring speech (though the main part of the decision delivered by Lord Templeman and the other law lords concurring with that part did not include a similar remark):

113
... it is no doubt correct that the mere fact that the taxpayer borrows money in order to incur capital expenditure does not prevent him from qualifying for a capital allowance under the section; likewise the mere fact that such a loan is a non-recourse loan in the sense that the taxpayer is not personally liable for its repayment, the loan being repayable out of property or proceeds in the hands of the taxpayer, will not of itself prevent the transaction from constituting what is in truth a loan, or the expenditure so financed qualifying for a capital allowance.

5.4.5.4. German leveraged leases

The major relevant features of a typical German leveraged lease (GLL) are as follows:

- a special-purpose vehicle (lessee SPV) in the form of a limited partnership (KG) is established to carry out a lease transaction;\(^{257}\)
- the lessor, generally a limited liability company, acts as the general partner of the KG (i.e. lessor SPV). Also, the lessor acts as the manager of the lessor SPV;
- the equity investors make investment by way of acquisition of the limited partnership interest in the lessor SPV;
- the lessor SPV leases the asset to the lessee; the lessor resorts to debt-funding for financing a substantial part of the cost of the leased asset;
- the lease transaction is designed in the manner such that the lessor SPV\(^{258}\) would qualify as the economic owner of the leased asset, hence is entitled to the tax depreciation on the leased asset;
- the lessor SPV, being a limited partnership, is treated as a fiscally transparent entity;
- any loss resulting from the excess of lease expenses (i.e. tax depreciation, interest expense and any other related expenses) over the gross lease rentals is passed through to the partners of the lessor SPV, for setting-off against their other taxable income.

It is relevant to note that the tax advantage, i.e. set-off of the tax loss attributable to a partner (the equity investor) in the lessor SPV against the said partner’s taxable income from other sources is now neutralized by the introduction of Sec. 2b of the German Income Tax Act. As per Sec. 2b of the German Income Tax Act, where a tax benefit is the predominant reason for

\(^{257}\) See on the web site of Freshfields Bruckhaus Deringer, “Lessor insolvency in Germany: legal myths”.
\(^{258}\) And not the lessee.
making a tax-advantaged investment.\textsuperscript{259} Losses from such investments are
subjected to a “basket treatment”.\textsuperscript{260} One of the situations where investment
is assumed to be motivated by a tax benefit is where the post-tax yield on
investment is more than twice the pre-tax yield on investment. In such
cases, a loss from investments subject to the basket treatment can be set off
only against the income from other investments subject to similar basket

treatment.

It appears that the equity investments in fiscally transparent partnerships
(KGs) used as special-purpose vehicles for German leveraged leases
(GLLs) are generally regarded as tax-advantaged investments subject to the
said basket treatment. Accordingly, the restrictive provisions of Sec. 2b of
the German Income Tax Act negate the possibility of setting off the loss
from a GLL transaction against the other taxable income of the equity in-
vestor (i.e. a partner in the KG).

Research indicates that the typical GLL structure described above was suit-
ably modified in the case of at least one transaction (discussed at 5.4.5.5.)
to overcome the restrictive provisions of Sec. 2b of the German Income Tax
Act.

5.4.5.5. Modified German leveraged leases (modified subsequent to
Sec. 2b introduction)

In 2001, at least one lease transaction was closed for lease of three A321
aircraft to Air Canada, where the typical GLL structure was modified with
a view to the restrictive provisions of Sec. 2b of the German In-
come Tax Act.\textsuperscript{261} The modification involved infusion of genuine asset risk
and investment risk in the lease transaction, so as to substantiate that the
transaction was not motivated by a mere tax advantage.

From the published literature\textsuperscript{262}, it appears that the key features of the Air
Canada A321 GLL transaction were as follows:

\textsuperscript{259} Particularly by way of interests in partnerships and other bodies of persons and sim-
ilar models.
\textsuperscript{260} Also see Schmidt, Stefan, “Germany: an update on leasing and tax rules”, \textit{Asset Fi-
\textsuperscript{261} See “GLL bounces back for Air Canada”, \textit{Asset Finance International} December
\textsuperscript{262} See “GLL bounces back for Air Canada”, \textit{Asset Finance International} December
a lessor SPV (presumably a KG) was established for leasing the aircraft to Air Canada;
the lease transaction was fully defeased, and the defeasance money was utilized to buy a Frankfurt Stock Exchange DAX tracker fund and certificates of deposit;
the lessor had a put option, that could be exercised at the end of the initial six-year period. If the lessor exercised the put option, the investors were to receive the certificates of deposit and the tracker fund;
if the lessor did not exercise the put option, then Air Canada had the option of extending the lease by four years;
if Air Canada did not exercise the lease renewal option, then the lessor was required to remarket the aircraft lease to a new lessee;
if Air Canada exercised the lease renewal option, then at the end of tenth year, Air Canada had the option to purchase the aircraft by transferring the tracker fund and the certificates of deposit to the lessor;
if Air Canada did not exercise the Aircraft purchase option at the end of the tenth year, then the lessor was responsible for selling the aircraft to a third party. Any amount of sale proceeds in excess of a pre-agreed value of 60% of the acquisition cost of the aircraft were to be shared between the lessor and Air Canada in the ratio of 25.1% and 74.9%.

As can be observed from the above structure, the lessor/equity investors took the genuine investment risk. Therefore, it should be possible to demonstrate that the lease is not a mere tax-motivated transaction, but it is based on sound business propositions. Therefore, the lessor SPV/equity investors should be able to argue that Sec. 2b should not apply in the present case.

Also, the lessor SPV should be regarded as the economic owner (during the lease term) of the aircraft, as it would retain more than 25% of the sale proceeds in excess of the pre-agreed fair market value i.e. 60% of the acquisition cost of the aircraft.

263. This put option is similar to the put option described in the Type 3 transaction at 3.3.3.3.
264. It appears that in return for the transfer of the tracker fund and the certificates of deposit, the aircraft would be transferred to Air Canada.
265. If the stock exchange index performs badly, the lessor may not exercise the put option.
266. As the fair market value is pre-agreed at 60% of the acquisition cost, it appears that Air Canada would compensate the lessor in case the actual fair market value at the end of year 10 falls below the said 60% value.
267. This arrangement is similar to the arrangement for sharing of excess gains between the lessor and the lessee (type 2 transaction discussed at 3.3.3.3.).
Accordingly, it appears that this structure retains the tax advantages of a GLL.

5.4.5.6. Japanese leveraged leases

This structure was popularly used between 1985 and 1999. Though, in theory, the use of JLL structures is still possible, the 1998 amendments in the Japanese tax laws have rendered them uneconomical for cross-border leasing.\(^{268}\) Hence, since 1999, the JLL structures can be effectively used only for domestic leasing.

The main relevant features of this structure are as follows:\(^{269}\)

- a special-purpose vehicle (lessor SPV) would be formed to carry out the lease transaction;
- the equity investors invest in the lessor SPV at least 20% of the cost of acquisition of the lease asset, and the balance cost of acquisition (not exceeding 80%) would be funded by way of non-recourse debt. This funding pattern would fulfil the necessary “minimum equity investment” condition under the safe-harbour arrangement discussed at 5.4.10.;
- the lessor SPV would acquire the asset, and lease the same to the lessee;
- the lease would be a full pay-out lease, so that the lessor SPV would recover the entire cost of acquisition and other related expenses including interest through the lease rentals from the lessee;
- the lease term would be 120% of the legal useful life of the leased asset; accordingly, the lease term would be 10 years in the case of a narrow-body aircraft, and 12 years in case of a wide-body aircraft;
- the lessee would be granted a purchase option, to acquire the leased asset at the end of the lease term;
- the transaction would be carefully designed, so as to comply with all other safe-harbour requirements.

This structure derives its name “leveraged lease” as it involves equity funding of only 20% (80% non-recourse debt funding), but the lessor SPV obtains 100% depreciation deduction.


This structure could facilitate effective tax deferral, since it is permissible for the lessor SPV to incur a tax loss from the lease transaction in the first half of the lease term, in accordance with the safe-harbour rules.

However, with effect from 1 April 1999, in the case of a finance lease to a non-resident lessee, the Japanese lessor is permitted to claim tax depreciation on the leased asset only by using the straight-line method. This restriction rendered the structure uneconomical for cross-border leasing.

5.4.6. Replacement leases

As discussed at 3.5.1.1., in a case where the lessee is a tax-exempt person (including a foreign person), depreciation deduction for the lessor is computed using ADS (Alternative Depreciation System – i.e. the straight-line method) instead of the generally applicable MACRS (Modified Accelerated Cost Recovery System – i.e. the double declining-balance method). Under the ADS, the statutory recovery period in respect of the leased asset is extended as compared to the statutory period under MACRS. To circumvent this disadvantage, earlier, the affected taxpayers attempted “replacement lease structures”.

In a replacement lease structure, a single lease term was divided into two parts – the initial lease term and the “replacement lease term”, although the loan was amortized over the full (combined) lease term. After the initial lease term, if the equipment was not purchased by the foreign lessee, he had no right to use the equipment, and was contractually obliged to either arrange for a replacement lessee or return the equipment to the lessor along with a stipulated loss value (minus 20%).

Earlier, a Private Letter Ruling confirmed that, in a replacement lease, the leased property may be depreciated over 125% of the initial lease term, without having regard to the replacement lease term. However, this ruling was withdrawn on 3 November 1993.

1.168(i)-2 now require the replacement lease term to be included for the purposes of computing depreciation under ADS. Thus, the replacement lease structure no longer provides a tax advantage.

5.4.7. Like-kind exchange structure

It appears that in the mid-nineties, at least a few cross-border lease transactions involved an intercompany like-kind property exchange structure.274 Broad features of the said structures were as follows:

- typically, such structures involved a US domestic parent company that had two US domestic leasing subsidiaries (subsidiary A and subsidiary B);
- subsidiary A owned a fully depreciated leased asset that was used in the United States;
- subsidiary A sought to acquire a new equipment for leasing to a foreign lessee, for use outside the United States. However, the US tax depreciation rules (the ADS) in respect of the assets used outside the United States could render the transaction uneconomical and unviable;
- to overcome the hurdle of the said depreciation rules, instead of subsidiary A, subsidiary B acquired the new asset in its own capacity with the same value as subsidiary A's old (fully depreciated) equipment;
- then, subsidiary B exchanged the new asset for subsidiary A's used equipment. The non-recognition rule contained in IRC Sec. 1031 and Sec. 1.1502-13 of the Treasury Regulations facilitated deferral of the tax consequences of any gain or loss on the said exchange.275

Under Sec. 1031, generally, a taxpayer has a basis in the property acquired equal to the basis it had in the property exchanged. Accordingly, subsidiary B was treated as having acquired the (used) equipment that was used in the United States for the purchase price of the new equipment, and was entitled to depreciate the asset over the purchase price of the new equipment using

273. T.D. 8667, 4-26-96. For a discussion on the Regulations, see Park, E. John, “Cross-border Equipment Leasing: Recent Developments Related to Section 168(g)”, Virginia Tax Review Fall 1996.
275. IRC Sec. 1031 provides that if property held for productive use in a trade or business is exchanged for like-kind property, then no gain or loss will be recognized for US federal income tax purposes, except to the extent the transaction involves a boot, i.e. a cash payment to equalize the values. Sec. 1.1502-13 of the Treasury Regulations provides that the gain or loss on exchanges between the members of a consolidated group will be deterred, until the property leaves the group.
the normal MACRS depreciation rules. Since Subsidiary A did not have a basis in the used equipment, it did not acquire any basis in the new equipment it received from subsidiary B. As a result of the consolidated group taxation, the group as a whole had nothing to lose, rather it avoided the negative impact of restrictive rules that subsidiary A would have suffered.

However, the Final Regulations 1.168(h)-1\textsuperscript{276} now neutralize this advantage.

\textbf{5.4.8. Lease-in-lease-out (LILO)}

In recent years, LILO transactions were extensively used as a technique to avoid the less advantageous deprecations rules (ADS) in the case of lease of property to tax-exempt persons (including foreign persons).\textsuperscript{277}

In a LILO transaction, the foreign end user of the property purchased the property. The US investor acquired the leasehold interest (headlease) in the said property from the foreign owner (the end user), and subleased the same back to the foreign owner/end user of the property. Accordingly, the structure derived its name “lease-in-lease-out”. In such a transaction, the US investor made upfront payment of substantial (if not complete) portion of his future lease obligations under the headlease (i.e. the first leg of the transaction/leasing of the property by the US investor from the foreign owner). However, under the sublease (i.e. the second leg of the transaction/subleasing or leasing-back of the property by the end user from the US investor) the US investor was entitled to receive sublease rentals from the sublessee (the end user of the property) on an equated basis. Thus, the US investor could obtain a substantial amount of upfront deduction on account of the excess of upfront headlease payments over his entitlements to receive sublease rentals in the initial years of the transactions.

However, as now the scope of the Final Sec. 467 Regulations also includes qualified leasebacks, the tax advantage of LILO transactions on account of

\textsuperscript{276} T.D. 8667, 4-26-96.
uneven lease rentals (including prepayment of rentals under the headlease) is neutralized.

It is also relevant to note that in a revenue ruling, the IRS viewed LILO as a transaction lacking economic substance and undertaken solely with the motive of tax avoidance.278

5.4.9. Tax sparing credit (TSC) structures

In February 2000, the Dutch Supreme Court decided on a case involving a lease structure with effective use of tax sparing credit under the Netherlands–China tax treaty.279 The key features of the structure were as follows:

- a wholly owned Dutch subsidiary ("the equity owner") of a Dutch bank acquired a 75% interest in another Dutch company ("the lessor company"). An independent third party owned the balance 25% interest in the lessor company;
- the equity owner funded its acquisition in the lessor company with the help of a loan from the parent Dutch bank;
- the lessor company, using its equity capital, purchased two aircraft and leased (operating lease) them to a Chinese airline;
- China did not impose any withholding tax on lease rental payments by the Chinese airline to the Dutch lessor company. Under the Netherlands–China tax treaty, the lessor was entitled to a tax sparing credit of 15% deemed Chinese tax on the gross amount of the lease rentals;
- due to the 15% tax sparing credit (on the gross lease rental income), after taking into account the deduction for depreciation on the aircraft and other related expenses, the Dutch lessor company did not have to pay tax in the Netherlands;
- in respect of the dividend distribution by the lessor company to the equity owner, the equity owner claimed the Dutch participation exemption.

The above structure demonstrates how the tax sparing credit under a tax treaty may be utilized in a lease transaction.

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Also, it is relevant to note that the Dutch tax authorities’ attempt to disallow the deduction for interest payment by the equity owner to its parent bank was overruled by the Dutch Supreme Court.

5.4.10. Japanese safe-harbour structures (agreement between Japanese tax authorities and Japan Leasing Association280)

In the late 1980s, The Japan Leasing Association (JLA) negotiated safe-harbour rules with the Japanese National Tax Authorities (NTA).281 The members of the JLA committed to the NTA to observe certain criteria/parameters in leasing transactions. In return, the NTA agreed to recognize leasing transactions as genuine lease transactions if all of the following requirements are satisfied:

– The leased asset (in the case of aircraft) has a high second-hand value at the end of the lease term, and such value constitutes a high percentage of the acquisition cost of the leased asset at the inception of the lease;

– The “loss preceding ratio” of the depreciation expense of the leased property under the following formula does not exceed 160%:

\[
\text{loss preceding ratio} = \frac{B}{A}
\]

Where:

\(A\) = the aggregate of the excess of the annual depreciation expense over the annual gross lease rentals in the early years of the lease when such excess causes losses to the lessor under a hypothetical lease transaction in which (i) the interest rate is 5.5% (ii) the residual value of the leased asset is 10% of the acquisition cost and (iii) the lease period is the legal useful life of the leased asset

\(B\) = the aggregate of the excess of the annual depreciation expense over the annual gross lease rentals in the early years of the actual lease transaction when such excess causes losses to the lessor under a hypothetical lease transaction

Tax-driven leasing transaction structures

- The purchase option price (at which the lessee may purchase the leased asset from the lessor at the end of the lease term) is less than 45% of the acquisition cost of the leased asset, and also, such option price does not exceed the estimated second-hand market price of the leased asset.

- The lessor does not have negative income (i.e. gross lease rentals minus depreciation minus interest expense) under the leasing transaction for more than 50% of the number of years in a lease term.

- Where the lessor borrows funds for a lease transaction, the lessor’s own equity investment in the lease transaction is at least 20% of the acquisition cost of the leased asset.

- The total (over the lease term) taxable income of the lessor until the sale of the leased asset after the expiry of the lease term is at least 1% of the acquisition cost of the leased asset.

5.4.11. Tokumei Kumiai arrangements

Tokumei Kumiai (TK) arrangements are commonly used for structuring lease transactions. A “Tokumei Kumiai” is a silent partnership formed under Arts. 535 to 542 of the Japanese Commercial Code. A TK does not have separate legal personality, and it is treated as a transparent/flow-through entity.

As the TK is a flow-through entity, the profit or loss from a TK is passed through to the partners in the ratio of their ownership of interest in the TK.

For leasing transactions, a TK appears to be a commonly used form of special-purpose vehicle by the lessors. Accordingly, the lessor would estab-

282. See, for a typical TK structure, Takisaki, Akio, “Taxation of the Tokumei Kumiai Used in Real Estate Syndication”, Shin Hihon Ernst & Young (web site).
284. In essence, a TK arrangement has the same effects as in the case of use of trusts as lessor in certain jurisdictions, where a trust is treated as a flow-through “entity” and income and losses of the trust are passed on to the beneficiaries.
lish a TK to be used as the special-purpose vehicle for leasing the assets to the lessee. The equity investors would make their equity investment by way of acquiring interests in the TK. The net taxable income (i.e. gross lease rentals minus depreciation deduction minus interest and other relevant expenses) of the TK is passed through to the equity investors in their ratio of ownership of interest in the TK. As a result, any tax loss (particularly in the early years) from the lease transaction is passed through to the equity investors who can set off the same against their taxable income. Often, this constitutes a significant advantage.

5.4.12. Japanese operating leasing (JOL)

As stated earlier, with effect from 1 April 1999 a Japanese lessor in a finance lease is allowed tax depreciation on the leased asset only by using the straight-line method. This restriction rendered the Japanese leveraged leasing uneconomical for cross-border leasing.

Since 1999, JOL is used as an alternative to the Japanese leveraged leasing. The major relevant features of a typical JOL are as follows:

- a special-purpose vehicle (lessee SPV) is formed to carry out the lease transaction;
- the equity investors invest in the lessee SPV at least 20% of the cost of acquisition of the leased asset, and the balance cost of acquisition (not exceeding 80%) would be funded by way of non-recourse debt;
- the lessee SPV would lease the asset to the lessee;
- unlike in case of a JLL, the lease would not be a full pay-out lease, so that the future lease rental payments by the lessee would cover not more than 90% of the acquisition cost of the asset. However, from a more conservative viewpoint, the lease rentals may cover only 80% of

286. Use of TK can be combined with Japanese leveraged lease, Japanese operating lease, etc.
288. It appears that the JLA has reached an understanding with the Japanese tax authorities that equity investors would fund (by way of equity investment) at least 20% of the acquisition cost of the leased asset. See presentation “Developments in the use of the Japanese operating leasing”, by Michael J. Lawrence at Structured Finance Institute Conference, 19 March 2001.
the acquisition cost.\textsuperscript{289} This non-full pay-out feature would cause classification of the lease as an operating lease;

- the lessee may or may not have the purchase option to acquire the leased asset at the end of the lease term for a pre-estimated fair market value.\textsuperscript{290} Where the lessee does not exercise the purchase option, the lessor would be required to remarket the leased asset, or sell the leased asset to a third party;

- being an operating lease, the ceiling of 120\%\textsuperscript{291} of the legal useful life would not apply to a JOL. Accordingly, the lease term in a JOL could be longer than the lease term in a JLL. For example, in case of lease of an aircraft, the lease term in a JOL could be up to 15 to 20 years as compared to 10 to 12 years in JLL.\textsuperscript{292}

A comparison between the JLL structure and the JOL structure reveals that most of the features in the two structures are common, except for the following differences:

- JOL is a non-full pay-out lease, the lease rentals covering 80\% to 90\% of the acquisition cost of the leased asset. In other words, the lessor has 10\% to 20\% asset/residual value risk, since recovery of 10\% to 20\% of the acquisition cost of the leased asset depends upon the lessee exercising the purchase option (at the estimated fair market value) at the end of the lease term, or alternatively, proceeds from sale of the leased asset to a third party;

- the length of the lease term could be longer (beyond 120\% of the legal useful life of the asset) under a JOL as compared to a JLL.

As the lessor is able to depreciate the leased asset using the declining-balance method, the lessor is able to obtain significant tax advantage (comparable with the tax advantage under JLL). This advantage enables Japanese lessors to market JOL deals competitively.


\textsuperscript{290} As the option price is based on the estimated fair market value of the leased asset at the end of the lease term, the exercise of such an option by the lessee should not be regarded as reasonably certain at the inception of the lease. Therefore, such option price should not be added to the aggregate lease rentals for determining the full pay-out (or otherwise) status of the lease contract in accordance with JCTL Circular item 12-2-1-3.

\textsuperscript{291} Prescribed in JCTL Circular item 12-2-2-7; see discussion at 2.6.1.

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5.4.13. Defeasance structures

5.4.13.1. Nature of transaction

Under this structure, the lessee would defease his future lease rental obligations, by paying to a defeasance bank the present value of the future lease rentals. The lessee, besides the tax depreciation benefits passed on (by way of pricing) by the lessor, also obtains the benefit of the time value of money. The defeasance banker would assume the responsibility for fulfilling the lessee’s future lease rental obligations. Also, often, the defeasance banker would act as a lender to the lessor SPV in the leveraged-lease transaction. Thus, in effect, the lessee may be financing a substantial portion (up to 80%) of the acquisition cost of the leased asset.


5.4.13.2. UK Court of Appeals decision in *Barclays Mercantile Business Finance Ltd. v. Mawson (Inspector of Taxes)*

5.4.13.2.1. Relevant facts

**Payment flow on 31 December 1993**

![Diagram of payment flow]

**Parties to the transaction:**

- **BB**: Barclays Bank Plc (BB), UK
- **BMBF**: Barclays Mercantile Business Finance Ltd., UK, a company within the Barclays group, was engaged in the business of asset-based financing
- **BGE**: Bord Gais Eireann, an Irish corporation owned by the Irish government and responsible for supply, transmission and distribution of natural gas in Ireland, had built a gas pipeline running from Scotland to Ireland
- **BGEUK**: BGE (UK) Ltd., wholly owned subsidiary (BGE UK), incorporated in the United Kingdom
- **Deepstream**: Deepstream Investments Ltd., a Jersey company
- **Barclays (IOM)**: Barclays Bank Finance Co (Isle of Man) Ltd., an Isle of Man company in Barclays group

**Transaction/cash flow on 31 December 1993**

BMBF agreed to acquire from BGE certain plant and machinery related to the pipeline (hereinafter referred to as “pipeline”) for consideration of GBP 296. [2003] STC 66.
91 million. BMBF borrowed GBP 91 million from Barclays Bank ("BB") at a fixed rate of interest of 10.95%, and paid the purchase consideration to BGE.

BMBF leased (hereafter referred as "headlease") the pipeline to BGE for a pre-primary period running from 31 December 1993 to 30 September 1995, to be followed by a primary period running from 1 October 1995 to 30 September 2025. BGE had the option to renew the lease beyond 30 September 2025.

BGE subleased the pipeline to BGEUK for the identical lease term and rentals as in case of the headlease. BMBF agreed to raise invoices on BGEUK for the rentals due from BGE, and BGEUK agreed to discharge its rental obligations under the sublease, by settling the said invoices.

Under an agreement between BGE and BGEUK, BGEUK agreed to transport, handle and deliver gas to BGE's order for a specified remuneration. The said remuneration was to be paid by BGE into a designated bank account of BGEUK ("transportation account"), and it was adequate to enable BGEUK to pay rentals to BMBF.

Under an arrangement between BGE, BB and BGEUK, BB was authorized to debit about GBP 91 million from BGE's account with BB as soon as it was received from BMBF (as sale consideration for the pipeline) and to pay that amount to the account of a Jersey company, Deepstream Investments Ltd ("Deepstream"), with BB. By virtue of an agreement, BGE agreed to deposit the amount of GBP 91 million with Deepstream, and Deepstream agreed to repay the said amount in three Categories A, B and C. Category A matched the rentals payable to BMBF, Category B was comprised of relatively small amounts, whereas Category C was comprised of even smaller amounts. Amounts under Categories B and C were for BGE's own benefit.

Deepstream deposited the amount received by it from BGE with another company within the Barclays group, i.e. Barclays Finance Co (Isle of Man) Ltd ("Barclays IOM").

Barclays IOM paid into BB's treasury the amount deposited by Deepstream with Barclays IOM.
Guarantees/deeds of indemnity executed by various parties

As security for its obligations under the transportation agreement, BGE assigned its interest in the deposit with Deepstream to BGEUK and charged its current account in favour of BGEUK.

BB provided a guarantee to BMBF in respect of rental payments by BGEUK to BMBF.

BGEUK executed a Deed of Indemnity in favour of BB, and assigned to BB its interest in the deposit with Deepstream, the BGE account and its rights under the transportation agreement, and charged the transportation account in favour of BB.

Deepstream executed a Deed of Indemnity in favour of BB in respect of BB's obligations under the Barclays Guarantee and assigned to BB the rights to the amount deposited with it, granted BB fixed and floating charges over all its assets, and charged in favour of BB the account with Barclays IOM;

5.4.13.2.2. Position taken by the tax authorities

The tax authorities did not regard the transaction as an ordinary finance lease transaction, and in its view BGE did not obtain any finance by virtue of the transaction. Though the tax authorities did not regard the transaction as a sham, it sought to apply the Ramsay principle. The tax authorities took the view that on the ground of the circularity of payments, BMBF did not incur any expenditure. And, even if BMBF were to be regarded as having incurred expenditure, such expenditure was not for acquisition of the pipeline, and hence did not qualify for capital allowance. The tax authorities also alleged that the transaction was not a trading transaction.

5.4.13.2.3. Decision by the Special Commissioners

The Special Commissioners rejected the contention of BMBF's counsel that they should not look beyond the action of BMBF. The Special Commissioners accepted the argument of the counsel of the tax authorities that they were required to look at the transaction in its entirety.

The Special Commissioners opined that:
- the payment by BMBF to BGE did not have a commercial purpose;
Chapte rr  5  -  Limit s  o f  tax-drive n  cross-borde r  leasin g  transactio ns

- unlike commercially driven finance leasing, which is designed to provide working capital to the lessee, BGE could not get its hand on the consideration for the sale of the pipeline;
- the lease did not provide any finance to BGE since, as a part of the arrangement, BGE had to deposit the sale consideration with Deepstream;
- the purpose of the expenditure by BMBF was not the acquisition of the plant and machinery, but the obtaining of capital allowances that would result in ultimately a profit to BGE and the fees payable to BMBF.

Accordingly, the Special Commissioners held that BMBF was not entitled to capital allowances in respect of the pipeline.

5.4.13.2.4. High Court decision

In the second appeal, the High Court did not regard the transaction as a tax avoidance scheme. However, the High Court did not regard the transaction as ordinary finance leasing that normally enables the lessee to either (i) have the use of an asset that it would not have in the absence of the lease or (ii) use the proceeds of the sale (in a sale-and-leaseback transaction) to repay the borrowings or for other purposes of the lessee’s business.

The judge opined that as regards finance leasing the underlying purpose of Parliament is to enable capital allowances to be used to provide finance to lessees at attractive rates to enable them to develop their business activities.

As regards the nature of the expenditure incurred by BMBF, the High Court held that it was incurred on the creation or provision of a complex network of agreements under which, in an almost entirely secured way, money flows would take place annually over the next 32 years so as to recoup to BMBF its outlay of GBP 91 million plus a profit. The judge opined that, from a commercial perspective, BMBF had incurred expenditure to obtain its rights in respect of the said money flows (rather than for acquisition of the pipeline).

Further, while accepting that finance lessors always wish to limit the credit risk in the transaction, the judge opined that where the credit risk is removed comprehensively (as in the transaction under dispute), it would appear that the lessor had not laid out its money on a leasing transaction at all. However, he did not accept the tax authorities’ view that BMBF did not incur any expenditure at all. Indeed, he accepted the contention of the tax au-
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 Authorities that BMBF did not incur the expenditure wholly and exclusively for the purpose of its trade, since the transaction was predominantly driven by a fiscal element, i.e. BMBF’s potential entitlement to capital allowances on the pipeline. 297

Accordingly, the High Court ruled that BMBF was not entitled to capital allowances in respect of the pipeline. 298

5.4.13.2.5. Court of Appeals decision

Overturning the characterization adopted by the Special Commissioners and the High Court, the Court of Appeals found the transaction commercial in nature, particularly in view of the fact that Deepstream, Barclays IOM and BB participated in the transaction on ordinary commercial terms. The court found the anxiety of the parties to the transaction to minimize the credit risk justifiable in view of the magnitude and duration of the transaction. 299 Accordingly, the Court did not find minimization of credit risk as the element that could jeopardize the characterization of the lessor’s investment in the lease.

Next, the Court of Appeals did not agree with the conclusion reached by the High Court that, as regards finance leasing, the underlying purpose of Parliament was to enable capital allowances to be used (by the lessor) in a manner that would enable the lessees to fund the assets acquisition at attractive rates of finance, in the absence of any such indication by the legislation. The Court of Appeals also rejected the view expressed by the High Court that (i) the inability of BG E to “get its hands on the money” demonstrated that there was no expenditure by BMBF on the pipeline, and (ii) the finance lease must provide some “upfront finance” to the lessee and the lessor must

297. The judge reached this conclusion on the basis of a distinction drawn in F A and A B Ltd v. Lupton (Inspector of Taxes) [1968] 1 WLR 1401, 47 TC 580 between: (1) transactions that have fiscal elements but which are nevertheless trading transactions and (2) transactions where the fiscal elements are present to such an extent that the transactions are not trading transactions at all.
298. Also see Johnson, Trevor, “U.K. Tax Update: Like a Circle in a Spiral, Like a Wheel Within a Wheel”, Tax Notes of International 9 September 2002.
299. The Court observed that except for the pipeline itself as the security, the guarantee provided by BB to BMBF was adequate only for the “strip risk” (i.e. the difference between the maximum sum payable by BMBF upon termination of the lease and the amount of the guarantee by BB), estimated at GBP 25 million. Therefore, the Court did not find it surprising that BMBF sought to ensure that it would receive the covenanted rental payments by having in place the “scheme of deposits” (from BG E to Deepstream, from Deepstream to Barclays IOM and finally from Barclays IOM to BB).
bear some degree of credit risk to be entitled to capital allowances. The Court of Appeals categorically stated that the fact that the trader incurring the capital expenditure on plant or machinery would not himself use the plant or machinery but would lease it and pass on the benefit of the capital allowance to the lessee does not constitute a valid reason for denial of capital allowances to the lessor. The Court of Appeals opined that, subject to Sec. 75(1),\(^3\) it is immaterial how the trader acquires the funds to incur the capital expenditure on the plant or machinery or what the vendor of the plant or machinery does with the consideration received; as long as the capital expenditure on plant or machinery is incurred wholly and exclusively for the purposes of the trader’s trade, it is irrelevant whether or not the trader’s purpose behind such expenditure was to obtain capital allowances.

The Court of Appeals expressed that BMBF had incurred a real expenditure on the acquisition of the pipeline, and it was irrelevant for BMBF’s entitlement for capital allowance that BMBF’s funds for such acquisition originated from BB out of BB’s Treasury and that it ended up back in BB’s Treasury after passing through the hands of BMBF, BGE, Deepstream and Barclays (IOM).

Also, as the transaction did not involve self-cancelling payments or uneconomic loans, and as each step was properly commercial and on arm’s length terms, the Court of Appeals rejected the contention of the tax authorities that the Ramsay principle should apply because the money used by BMBF went in a circular way.

Accordingly, reversing the decision of the High Court, the Court of Appeals confirmed BMBF’s entitlement to capital allowances.

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300. Sec. 75(1)(c) of the Capital Allowances Act 1990 disallowed first-year allowance where the sole or main benefit that might have been expected to accrue was the obtaining of a first-year allowance.