International taxation of cross-border leasing income
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CHAPTER 9
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

9.1. Background

Section 9.2. contains a summary of the thesis as well as conclusions on the key research issues analysed in course of the research. Section 9.3. includes recommendations for lawmakers and treaty negotiators.

9.2. Summary and conclusions

9.2.1. Income recognition aspects

9.2.1.1. The tax deferral advantage of rear-loaded lease rentals

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

9.2.1.2. Relevant anti-avoidance provisions in select jurisdictions

An examination of the tax laws of the jurisdictions selected for the purposes of this research provides divergent results. While the Internal Revenue Code (combined with the Regulations) in the United States, and the Finance Act 1997 (Schedule 12) in the United Kingdom contain anti-avoidance rules for neutralizing the tax advantages of a lease arrangement with uneven lease rentals, it is found that such anti-avoidance provisions are not warranted in Germany and Japan since the German and the Japanese tax laws require income to be recognized on an accrual basis in accordance

517. I.e. by receiving a greater part of the total lease rentals in the later part of the lease term.
with the Generally Accepted Accounting Principles. The Dutch tax law does not include anti-avoidance provisions to prevent a lessor from obtaining a tax advantage by receiving a greater amount of lease rentals during the later years of the lease term.

9.2.1.3. Effectiveness of anti-avoidance provisions in the United States vis-à-vis the United Kingdom

In the United States, the tax advantages of a rear-loaded (as well as front-loaded) lease arrangement are effectively neutralized by virtue of the provisions of IRC Sec. 467 and the Final Sec. 467 Regulations. The said provisions, particularly the Final Sec. 467 Regulations, are very detailed and exceedingly complicated.

In the United Kingdom, unlike IRC Sec. 467 combined with Final Sec. 467 Regulations, it is submitted that the relevant provisions of the UK Finance Act 1997, Schedule 12, Part 2 are not adequate to completely eliminate the tax advantage of a rear-loaded lease, for the reasons discussed at 5.4.5.2.

9.2.2. Depreciation aspects

9.2.2.1. Significance of depreciation allowance in tax-driven leasing transactions

Normally, tax depreciation in respect of a leased asset constitutes one of the most substantial items of deduction in the computation of a lessor’s taxable income (in the residence state). Often, during the early years of a lease term, the allowable tax depreciation would exceed the gross lease rental income, which would generate a tax loss (but not the actual financial loss) for the lessor. The tax loss provides advantage to the lessor on two counts:

(1) the lessor’s tax liability in respect of the leasing income is postponed to a later year (i.e. deferred tax liability); and
(2) the lessor or a group company may be able to set off the tax loss against other taxable income.

On account of the “time value of money”, the deferred tax liability has a quantifiable value, a substantial part of which the lessor passes on to the lessee in the form of a reduction of lease rentals.
In cross-border leasing, it may be possible for lessors and lessees to obtain even greater benefits (as compared to domestic leasing transactions) by exploiting the differences in the tax depreciation rules under the tax laws of various countries. The study reveals that such differences may be classified into the following four categories, as differences on account of:

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

9.2.2.2. General scheme of depreciation allowances in the select jurisdictions

Research reveals diversity in the general schemes of depreciation allowances under the tax laws of the select jurisdictions.

In the United States, for most personal property, the taxpayers are permitted to follow the “double declining-balance method”, that is also known as the Modified Accelerated Cost Recovery System (“MACRS”). Under the MACRS, depreciation is allowed at 200% of the rate applicable under the straight-line method. As an interesting feature of the MACRS, at the point when the double declining-balance method would produce a depreciation deduction less than the depreciation deduction under the straight-line method, the taxpayer is permitted to switch over to the straight-line method.

In the United Kingdom, the depreciation allowance is referred as “capital allowance”, which is governed by the Capital Allowances Act 2001. The capital expenditure qualifying for capital allowances is required to be pooled together for the purposes of capital allowances (also referred to as writing-down allowances), balancing charges and balancing allowances. Ordinarily, most items of plant and machinery are subject to capital allowances at the rate of 25% on the written-down value basis (declining-balance method). Long-life assets (i.e. assets with a useful economic life exceeding 25 years) are subject to capital allowances at the rate of 6%. Subject to certain exceptions, a taxpayer may elect to remove short-life assets (i.e. assets...
with an expected useful life of less than four years) from the general plant and machinery pool and hold them in the single-asset pool.

In Germany, for tax depreciation purposes, the straight-line method, declining-balance method and production method are recognized. In certain cases, some other specific methods (e.g. output method, depletion method) may be acceptable. However, the depreciation methods based on gross profit, the replacement cost of assets and the lump-sum writing-off of a business are specifically prohibited.

In the Netherlands, the straight-line method is the most commonly used depreciation method. However, where appropriate, other methods such as the declining-balance, unit-of-production or percentage depletion methods may be used. The Dutch tax law or regulations do not prescribe depreciation rates. The cost of the asset less estimated residual value is depreciated over the useful economic life of the asset. Assets (e.g. land) that are normally not subject to reduction in value are not depreciable.

In Japan, for tax purposes, the straight-line method and the declining-balance method are permissible depreciation methods. Certain types of fixed assets may be depreciated using the production method or the replacement method.

9.2.2.3. Eligibility criteria for depreciation allowance (legal v. economic ownership)

The study also reveals diversity in the eligibility criteria for grant of depreciation allowance. The diversity in the said criteria could be regarded as one of the main motivating factors for the taxpayers for resorting to leasing (including cross-border leasing) instead of conventional means of asset financing, such as by means of loan funding.

In the United States, the eligibility for tax depreciation in respect of a leased asset depends upon the economic ownership rather than its legal ownership. Accordingly, the characterization of the transaction is crucial for eligibility for depreciation allowance in respect of a leased asset. If the transaction is regarded as a “lease”, then the lessor is entitled to the tax depreciation in respect of the leased asset. Conversely, if the transaction is regarded as a “sale”, then the lessee is entitled to the tax depreciation on the leased asset.
In the United Kingdom, entitlement to capital allowances is based on the legal ownership rather than the economic ownership. Accordingly, a lessor is entitled to capital allowance irrespective of the nature of the lease being financial or operational. However, if the lease confers an option to the lessee for acquiring the leased asset in future, then the transaction is treated as a contract for hire-purchase, in which case the lessee (instead of the lessor) is entitled to capital allowances, subject to satisfaction of certain other conditions.

In Germany, the economic owner rather than the legal owner of the asset is entitled to depreciation. Generally, the economic owner of an asset is the person who enjoys unrestricted risks (e.g. the risk in respect of damage to the asset) and rewards (e.g. right to dispose of the asset). As per Paragraph 39, subsection 2, No. 1 Abgabenordnung (AO) (German Tax Code), a person other than the holder of the legal title under civil law may be treated as the economic owner of an asset if:

(i) the said person has the exclusive use of the asset for its normal useful life; and

(ii) the holder of the legal title is excluded from using the asset.

It is also relevant to take note of a landmark decision wherein the German Supreme Fiscal Court held that the economic ownership is regarded as transferred from the lessor to the lessee when:

- the usual economic useful life of the leased asset and the primary lease term are approximately equal; or

- the usual economic useful life of the leased asset is longer than the primary lease term, and the lessee has, at the end of the primary lease term, an option to either purchase the leased asset or to renew the lease, and the purchase price or the lease rental during the renewed lease term is considerably lower than the fair market value; or

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

Based on the said decision, the German tax authorities have issued circulars providing safe-harbour rules concerning the attribution of economic ownership in the case of full pay-out as well as non-full pay-out leases. The said circulars are binding on the tax authorities, but not on the taxpayers and the courts.
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In the Netherlands, the economic owner (and not the legal owner) of the asset is entitled to depreciation. As per a decision of the *Hoge Raad*, the legal owner (lessor) is also regarded as economic owner, except if all (and not some) economic interests/risks in the leased asset are shifted to the lessee.

As per the lease arrangement issued by the Dutch Ministry of Finance, the lessor is regarded as the economic owner of the leased asset if:
- the lessor conducts himself as the legal and beneficial owner of the leased asset;
- the lessor has the legal title to the leased property; and
- the lessor bears positive and/or negative risk with regard to the residual value of the leased property.

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

9.2.2.4. Incentives and restrictions

It is also relevant to note that the relevant incentives (discussed at 3.4.) in the form of accelerated depreciation allowance and restrictions (discussed at 3.5.), such as restricted depreciation allowance in the case of overseas leasing, could have remarkable influence on a tax-driven leasing transaction.

9.2.3. Transaction characterization aspects

9.2.3.1. Significance of transaction characterization

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

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519. I.e. taxability of the entire amount of the gross lease rentals vis-à-vis taxability of only the finance income part out of the gross lease rentals.

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The study reveals diversity in characterization principles under tax laws of the select jurisdictions. The tax laws of various jurisdictions may differ not only on account of characterization on the basis of legal form v. economic substance of the transactions, but even in the case of the tax systems that follow the economic substance of the transaction for characterization purposes, the parameters for recognition of a transaction as lease may differ (e.g. the dissimilarities between the circulars issued by the German Ministry of Finance and the lease decree issued by the Dutch Ministry of Finance (in respect of the Dutch lease arrangement) on the other hand).

9.2.3.2. Transaction characterization in select jurisdictions

In the United States, for the lessor to secure a depreciation deduction in respect of the leased asset the lease must qualify as a “true lease”. If the lease transaction is viewed as a conditional sale or a secured loan, the lessee would be considered as the owner of the leased equipment and hence would be entitled to the tax benefits associated with the ownership of the leased equipment. This may nullify the tax advantages of a leasing transaction.

A review of the relevant court decisions reveals that, generally, the courts in the United States tend to respect a transaction as “lease” if:

- the lease agreement confers a purchase option in favour of the lessee, the amount of lease rentals payable during the lease term is reasonable and the price at which the lessee is entitled to purchase the leased asset is not unreasonably low;
- the lease agreement does not confer a purchase option in favour of the lessee, but the lessee eventually acquires the leased asset from the lessor, since such acquisition does not necessarily provide an inference that the lessee had a legal right as such to acquire the said equipment prior to the actual acquisition;
- in the case of a purchase option in favour of the lessee, the predetermined purchase price is based on the expected value of the leased asset; or
- the lease agreement does not confer a purchase option in favour of the lessee; the lessee is obliged to return the leased asset to the lessor after the expiry of the primary or extended lease term, and the lessor realizes significant income from scrapping of the returned equipment and follows elaborate procedures for locating/identifying the leased equipment.
Conversely, the courts generally tend to recharacterize a lease agreement as a “conditional sale”, if:

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

In the United Kingdom, characterization of a lease transaction is based on its legal form rather than the economic substance, except where a lease involves a purchase option, in which case the transaction is deemed to be a contract for hire-purchase. Accordingly, in the case of a lease not conferring the purchase option to the lessee, the characterization issue (i.e. lease v. sale) does not arise.

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

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

(i) during or at the end of the lease term, the leased asset is to be sold to the lessee free of charge or for a nominal compensatory amount;

(ii) during or at the end of the lease term, the lessee is granted an option to purchase the leased asset for a bargain price;

(iii) the lease is a “special lease”;

(iv) a substantial difference exists between the period of a lease contract and the statutory useful life of the leased asset.

9.2.4. Legal systems, anti-avoidance principles and aggressively tax-driven transaction structures

9.2.4.1. Tendencies of taxpayers towards aggressively tax-driven transactions

An analytical review of the various leasing transaction structures suggests that the taxpayers tend to undertake aggressively tax-driven leasing transactions with a view to:

- exploit the transaction characterization rules under the national tax laws (e.g. sale-and-leaseback, double-dip transactions, etc.);

- defer the taxation of leasing income (e.g. leases with rear-loaded rental payments);

- circumvent the specific 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 under tax laws or tax treaties (e.g. structures to benefit from the tax sparing credit provisions in tax treaties); or

- enhance the tax advantages by increasing the lessor’s capacity to lease (e.g. leveraged leases with non-recourse financing, defeasance structures, etc.).

The tax laws of many jurisdictions embrace specific restrictive or anti-avoidance provisions with a view to impede aggressive leasing transactions. However, due to the dynamic characteristics of the financial services industry, the players in the leasing arena have been able to innovate the
transaction structures beyond the ambit of the said specific restrictive or anti-avoidance provisions, that are inevitably followed by the consequential amendments in the national tax laws to plug loopholes.

9.2.4.2. Scope of general anti-avoidance rules

In the United States, the IRC does not specifically include a general anti-avoidance rule. 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. The US general anti-avoidance principles could be classified into the following doctrines:

- the sham transaction doctrine;
- the step transaction doctrine;
- the business purpose doctrine;
- the substance-over-form doctrine; and
- the economic substance doctrine or the economic sham transaction doctrine.

In the United Kingdom, the tax avoidance principles emerge from the House of Lords decision in *W.T. Ramsay v. IRC*, and subsequent decisions. However, the said anti-avoidance principles apply only in cases involving artificial transactions, and they do not affect genuine commercial transactions even if they are undertaken predominantly with the purpose of obtaining a tax benefit.

In Germany, the anti-avoidance rules do not apply to the transactions embodying economic substance, though obtaining a tax benefit may be the predominant purpose behind such transactions. In the Netherlands, the principle of *fraus legis* may apply in a situation 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 such a situation, the transaction may be recharacterized with a view to apply the tax treatment in accordance with the legislative intent and the economic substance. The *fraus legis* principle, however, does not apply to the transactions in which the taxpayer has a commercial motive.
9.2.4.3. Impact of legal systems on tax-driven cross-border leasing transactions

As discussed at 5.3., a legal system could substantially influence the tax consequences of a leasing transaction. For the purposes of this study, a legal system is examined 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 (formalist legal system) or towards substantive reasoning (substantive legal system).

As discussed at 5.3., 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. Though a formalistic legal system may afford a greater degree of certainty as regards the tax treatment of lease transactions, in such a 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. 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 the 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 the 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” as compared to a substantive legal culture. For that reason, 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

520. 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 the anti-avoidance rules may not be regarded as abusive.
transactions as compared to their counterparts in a substantive legal system.\textsuperscript{521} It is also submitted that since specific anti-avoidance provisions may not be pre-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, 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, 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 domestic lease transactions; and at the same time the parties to the transactions may have more possibilities of deriving tax benefits from a tax-driven lease. For the taxpayers to be able to exploit the differences between the two legal systems, it is not necessary that one legal system is 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 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 legal systems are formalistic, it would not be possible for the lessor and the lessee to simultaneously derive such an advantage since only one of the two parties (generally the lessor) would be regarded as the legal owner of the leased asset.

\textsuperscript{521} For the sake of 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 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., the 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 the taxpayers in a formalistic legal system 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.
9.2.4.4. Tax-driven transaction structures

As discussed in detail at 5.4., over the past few decades taxpayers have attempted several types of tax-driven transaction structures. While some transaction structures have succeeded in securing the targeted tax advantages, others have been rendered ineffective either on account of adverse court decisions or subsequent amendments in the anti-avoidance provisions under the relevant tax laws. While the nature of the said transaction structures as well as the relevant judicial and legislative (anti-avoidance) developments are analysed in detail at 5.4., the key conclusions in respect of the various transaction structures could be summarized as follows:

9.2.4.4.1. Sale-and-leaseback transactions

Respectability of a sale-and-leaseback transaction largely depends on the legal system followed by the concerned jurisdiction. Accordingly, while the Court of Appeals in the United Kingdom has recently respected a sale-and-finance-leaseback transaction (see discussion at 5.4.1.3.), sale-and-finance-leaseback transactions have not been recognized in the United States and the Netherlands due to their inherent economic substance being of the nature of financing rather than leasing (see discussions at 5.4.1.2. and 5.4.1.4.).

9.2.4.4.2. Chain-lease transaction structure

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. However, recently in BMBF (No. 24) Ltd v. Inland Revenue Commissioners, which case involved an overseas lessee, the High Court in England has ruled against the taxpayer, disallowing writing down allowances in accordance with the anti-avoidance provisions of the Capital Allowances Act 1990. Also, due to the explicit stipulation in the Capital Allowances Act 2001 that the references to a “lease” in the relevant anti-avoidance provisions (designed to frustrate the overseas leasing transactions) equally apply to “subleases”, the chain-lease structure is now rendered ineffective.
9.2.4.4.3. Double-dip leasing

For the reasons discussed at 5.4.3.4., it is submitted that, generally, a double-dip lease transaction must not be regarded as an abusive transaction, as long as it possesses the attributes of a commercial transaction entered into by the parties for sound business reasons.

9.2.4.4.4. Two-tier double-dip leasing

For the reasons discussed at 5.4.4.3., 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.

9.2.4.4.5. Leveraged leasing

9.2.4.4.5.1. Leveraged leases with uneven rents

In the United States, IRC Sec. 467 along with the Final Sec. 467 Regulations effectively neutralize the tax advantage of a lease with uneven rentals. In the United Kingdom, though Finance Act 1997, Schedule 12, Part 2 incorporates provisions with a view to counter finance leases with uneven rents, as demonstrated at 5.4.5.2., the tax advantage of a finance lease with rear-loaded rentals is only partly eliminated and it may be still possible for the taxpayers to obtain substantial advantages in the United Kingdom from a finance lease with rear-loaded lease rentals.

9.2.4.4.5.2. Leveraged leases involving non-recourse financing

Whereas the US IRC Sec. 465 frustrates a leveraged lease funded with non-recourse financing, for the reasons discussed at 5.4.5.3.3. it is submitted that the House of Lords decision in Ensign Tankers must not be viewed as a general rule affecting all lease transactions involving non-recourse financing. Accordingly, in cases involving genuine non-recourse loan attributes rather than the joint-venture attributes, a lessor should qualify for capital allowances on the entire cost of the leased asset.
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9.2.4.4.5.3. German leveraged and modified leveraged leases

As discussed at 5.4.5.4., Sec. 2b of the German Income Tax Act now neutralizes the tax advantage in a German leveraged lease. However, in the case of modified German leveraged leases similar to the transaction discussed at 5.4.5.5., Sec. 2b of the German Income Tax Act should not apply and the taxpayers may succeed in obtaining the tax advantage.

9.2.4.4.6. Defeasance structures

While a fully defeased lease is likely to be recharacterized as a sale transaction in the United States, the Court of Appeals in the United Kingdom has recently recognized a fully defeased structure as a lease transaction. This development supports the proposition advanced in this thesis that in the formalistic legal systems taxpayers have greater possibilities of obtaining tax advantages on the basis of the legal form of the transaction, as compared to taxpayers in substantive legal systems.

9.2.5. Tax treaty implications of transaction characterization

9.2.5.1. Tax treaty definition of “royalties”

Although the OECD 1992 MC excludes from the definition of “royalties” consideration for the use of or the right to use ICS equipment, the majority of the tax treaties entered into by the OECD Member Countries still include in the definition of royalties “consideration for use of or the right to use ICS equipment”.

9.2.5.2. Tax treaty characterization in the case of operating lease

As regards lease transactions purely in the nature of operating lease, the issue is relatively narrow and fairly simple: whether rentals for such leases amount to royalties under a tax treaty. The rentals for the operating leases of movable assets constituting ICS equipment would be governed by the royalties article, where the relevant tax treaty includes in the royalties definition consideration for the use of or the right to use ICS equipment. In other cases, operating lease rentals would normally be governed by the “Business profits” article (Art. 7).
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9.2.5.3. Tax treaty characterization in the case of finance lease

Finance lease transactions give rise to complex characterization issues, i.e. whether such income should be regarded as royalties, interest or business income. The conclusion on this issue, in turn, depends on the question as to whether the finance lease transaction should be viewed as a true lease, a transaction involving conditional/credit sale of the leased asset, or a loan transaction.

9.2.5.3.1. The issue of tax treaty characterization as “royalties”

As discussed at 6.4.1., it is submitted that where a transaction is recognized by the source state as a lease, the lease rentals paid by the lessee to the lessor could be viewed as payments for the use of or the right to use the leased asset. Accordingly, in such cases, if the definition of “royalties” in an applicable tax treaty includes consideration for the use of or the right to use ICS equipment, then lease rentals in respect of the ICS equipment would amount to royalties.

On the other hand, it is also submitted that in the case of a lease agreement that is regarded by the source state as a conditional sale instead of a lease due to its underlying economic substance, it would be inconsistent to regard the “lease rentals” paid by the lessee to the lessor as payments for the use of or the right to use the asset. Accordingly, in such cases, the payments by the lessee to the lessor in respect of the lease of ICS equipment must not be regarded as royalties under an applicable tax treaty, even if the definition of royalties in the tax treaty includes consideration for the use of or the right to use ICS equipment.

9.2.5.3.2. The issue of tax treaty characterization as “interest”

The next question is whether a lease rental that does not amount to royalties under an applicable tax treaty could be regarded as interest income for treaty purposes. The answer to the said question depends on the definition of “interest” in the relevant tax treaty. As discussed at 6.4.2.3., out of the 64 tax treaties analysed for the purposes of the research, most (90%) of the tax treaties define interest as:

522. Since a payment by the purchaser of an asset to the seller represents payment of the purchase consideration and not rent.
(a) income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying the right to participate in the debtor’s profits, and in particular, the income from government securities and the income from bonds or debentures, including the premiums and prizes attaching to such securities, bonds or debentures (similar to the OECD definition) [version A];523 or
(b) in addition to the income stated in (a) above, the income that is assimilated to the income from money lent by the taxation law of the source state [version B].524

For the reasons discussed at 6.4.2.4., where a tax treaty contains the version A interest definition, the finance lease rentals must not be regarded as interest for tax treaty purposes. As regards the tax treaties containing the version B definition of interest, the characterization of the finance lease rentals (as interest or otherwise) would depend upon the characterization under the national tax law of the source country. In the case of the tax treaties containing the version B interest definition, finance lease rentals would amount to interest if the United States is the source country (see discussion at 6.4.2.5.1.), whereas if the United Kingdom is the source country, the finance lease rentals must not be regarded as interest (see discussion at 6.4.2.5.2.). This issue does not assume practical significance in cases involving Germany or the Netherlands as source countries, since even if the finance lease rental was to be assumed to amount to interest, under the national tax laws of Germany and the Netherlands payment of such lease rentals would normally not be subject to withholding tax.

9.2.6. Differing provisions in tax treaties and improper use of tax treaties

9.2.6.1. Differing provisions in tax treaties

As pointed out in 7.2.1. to 7.2.3., a review of the 64 tax treaties selected for the purpose of the research reveals significant differences that may provide tax arbitrage opportunities in respect of cross-border leasing transactions.

523. 27 out of the 64 tax treaties define interest in this manner.
524. 33 out of the 64 tax treaties define interest in this manner. It is interesting to note that under the tax treaty between Norway and the United Kingdom, the term “interest” for UK tax purposes includes any item which under the law of the United Kingdom is treated as interest and for Norwegian tax purposes includes any item which under the law of Norway is treated as interest (but excludes any item which is treated as a dividend under the provisions of Art. 10 of the tax treaty).
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The said differing tax treaty provisions could have substantial impact (favourable or adverse) on the tax consequences of cross-border leasing transactions.

9.2.6.2. Improper use of tax treaties and entitlement to treaty application

With a view to obtain the benefits under a particular tax treaty, lessors from third-country jurisdictions might incorporate a leasing entity in one contracting state for leasing assets to lessees in the other contracting state. It is relevant to note that the motives behind setting up a leasing entity in foreign jurisdictions with favourable tax treaty networks could also include various commercial (non-tax) factors, as pointed out at 7.3.1.

It is submitted that where a leasing entity is established in a jurisdiction outside the residence state of the parent entity for a valid commercial reason, the issue of treaty abuse does not arise. However, if a parent company establishes a leasing entity in a jurisdiction other than its residence country predominantly for exploiting a favourable tax treaty network of that jurisdiction, such a manoeuvre may amount to “improper use” of tax treaties (treaty shopping). In such cases, it is relevant to examine as to whether the interposed leasing entity can claim the benefits under a tax treaty of the country of its residence.

For the reasons discussed at 7.3., it is submitted that it may be appropriate to conclude that in a case where a leasing entity is interposed by a parent entity in a jurisdiction other than the residence state of the parent entity, and if the leasing entity actively carries on substantive business activities (as opposed to being a mere “paper company”), the leasing entity should be entitled to claim the benefits under the tax treaties of its residence state. As the courts in some jurisdictions (e.g. the Netherlands and Germany) have allowed the treaty benefits even in the case of holding companies interposed solely for the purpose of securing a benefit under a tax treaty, if an interposed leasing entity has a business purpose and if it conducts actual leasing business in its residence state, then it is even more arguable that

525. For instance, to escape the “royalties” treatment of lease rentals in the source state in accordance with a tax treaty that excludes consideration for the use of or the right to use ICS equipment from the definition of royalties, or to escape the interest withholding tax, where a source state treats certain sale-and-leaseback transactions as financing arrangements, in accordance with a tax treaty that precludes the source state from taxing the interest income.
such an entity is eligible for the benefits under the treaties of its state of residence.

Also, as analysed at 7.3.2.1.3., it is submitted that the deviation by the OECD (in its 2003 version of the MC Commentary) from its original position is too broad and it is not in harmony with the fundamental object and context of the OECD MC and the tax treaties.

9.2.6.3. Implications of absence of “beneficial ownership” requirement in tax treaties

For the reasons discussed at length at 7.4.1.7., it is submitted that the “beneficial owner” provision in the OECD MC and the tax treaties is a substantive anti-treaty shopping measure rather than a mere clarificatory provision. Accordingly, in a case where the royalties article in a tax treaty provides for tax exemption or limited royalty taxation in the source country (if the recipient is resident in the residence state) without stipulating the “beneficial owner” requirement, then even an intermediate recipient must qualify for such favourable treatment.

In this regard, as also discussed at 7.4.1.7., it is submitted that a deviation by the OECD in its 2003 version of the MC Commentary is not in harmony with the treaty interpretation principles of the VCLT.

9.2.6.4. Effect of a typical “Limitation on benefits” article on leasing entities

In the case of cross-border leasing transactions, it is possible that a leasing entity is resident in a jurisdiction that has a tax treaty with the United States, but meets none of the tests (except “active trade or business” test) under the “Limitation on benefits” article of the tax treaty. In such a case, its entitlement to the tax treaty between its state of residence and the United States may depend entirely on the “active trade or business” test.

As discussed at 7.4.2., it is submitted that if the leasing entity actively conducts the activities of its leasing business from its residence state, including employing in the residence state the managers and other officers for funding, negotiating and executing the transactions in the residence state and if the key business decisions are taken by such managers and officers (rather than by the parent entity in a third country), then the income from leasing
transactions should be regarded as “connected with active trade or business” carried on in the residence state. In such a case, the lessor’s income from the leasing transactions should qualify for the tax treatment in accordance with the tax treaty between the lessor’s state of residence and the United States.

9.2.7. Relevance of EC Treaty in the context of cross-border leasing

9.2.7.1. EC freedom to provide services: leasing constitutes a service

As stated at 8.2.1.2., the ECJ has explicitly held in *Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna* that “leasing” is a service covered under the freedom to provide services.\(^{526}\)

9.2.7.2. Overseas leasing: capital allowance restrictions

For the reasons exhaustively discussed at 8.4.1., it is submitted that the capital allowance restrictions under the UK Capital Allowances Act 2001 in respect of assets leased to overseas lessees violate the EC freedom to provide services and, accordingly, are incompatible with the EC Treaty. Consequently, assets leased to the lessees in other EC Member States must qualify for capital allowances at the standard 25% rate, as if they were leased to lessees within the United Kingdom. It is also relevant to note that the entitlement of UK lessors to claim 25% capital allowances in respect of the assets used for overseas leasing is expected to provide extraordinary impetus to the leasing sector in the United Kingdom.

9.2.7.3. Compatibility of group relief regimes with the EC Treaty

For the reasons discussed at length at 8.4.2., it is submitted that the group relief denial, under the UK group relief regime, in respect of the losses suffered by group companies resident in the other EC Member States violates the EC freedom of establishment, and hence such treatment is incompatible with the EC Treaty. Based on the EC freedom of establishment, a UK group company must be allowed the group relief claim in respect of the losses suffered by a non-resident company within the same group, in the same man-

\(^{526}\) Case C-294/97, [1999] ECR 1-7447.
ner as in the case of losses suffered by another UK-resident group company. It is also relevant to note that this aspect could have substantial (favourable) implications for UK groups engaged in leasing activities, as explained in 8.4.2.1.

For the same reasons as discussed in 8.4.2., the conclusion reached in respect of the UK group relief regime should equally hold good for group relief regimes under the tax laws of the other EC Member States that deny group relief in respect of the losses suffered by group companies resident in the other EC Member States.

9.3. Recommendations

9.3.1. Amendments to the UK tax law for taxation of finance lease rentals on an accrual basis

As discussed in chapter 5, unlike the US IRC Sec. 467, the relevant provisions of the UK tax law$^527$ do not adequately counterbalance the tax advantage of a rear-loaded lease since the said provisions deem the “accountancy rental earnings” as the minimum taxable income in cases where the accountancy rental earnings exceed the normal rent.$^528$

Under the UK GAAP (SSAP 21), in the case of a finance lease, the accountancy rental earnings comprise only the finance charge (analogous to interest income on net investments) whereas the component of the gross lease rent corresponding to recovery of the cost of the leased asset is not treated as income. On the other hand, for tax purposes, the entire amount of the finance lease rent is regarded as income. However, in deeming the accountancy rental earnings to be the minimum taxable lease rental income, the UK Finance Act 1997 overlooks this fundamental difference between the treatments under the UK GAAP vis-à-vis the tax law principles. As a result, the Finance Act 1997 secures income recognition on an accrual basis only to the extent of the part of the gross finance lease rentals corresponding to the finance charge, and the finance lessor still has the possibility of deferring taxation of the part of the lease rentals corresponding to the recovery of the cost of the asset, which may constitute a substantial portion of the total gross lease rental income.

528. I.e. the rent receivable under the lease agreement.
It is submitted that the taxation of the gross finance lease rentals on an accrual basis can be effectively secured only by incorporating a self-contained “income recomputation mechanism”\textsuperscript{529} in UK tax law. The said mechanism must extend to the gross amount of the finance lease rentals, it must be based on the principle of time value of money, and it must operate independent of the accounting treatment of the finance lease rental income under the UK GAAP.

9.3.2. UK safe-harbour rules for leasing transactions

Out of the tax laws of the five jurisdictions examined for the purposes of the present research, only the UK tax law does not provide any kind of safe-harbour rules in respect of tax treatment of leasing income. However, incorporation of appropriate safe-harbour rules under the UK tax law may be highly recommendable, especially in view of the magnitude of leasing transactions, the tendency of taxpayers to undertake aggressively tax-driven transactions (for instance, sale-and-finance-leaseback transaction, as in the BMBF case) and the tendency on the part of the tax authorities to challenge such transactions.

Although it may be possible for taxpayers to undertake aggressively tax-driven transactions that do not meet the criteria of the safe-harbour rules and it cannot be ruled out that taxpayers successfully defend such transactions in courts due to the limited application of the general and specific anti-avoidance rules, it could be visualized that many risk-averse taxpayers may prefer structuring transactions in accordance with the safe-harbour rules. This would afford certainty as to the tax treatment of leasing transactions, and eliminate protracted litigation between taxpayers and the tax authorities. As a result, the safe-harbour rules could be expected to reduce the number of aggressively tax-driven leasing transactions, which would enable the tax authorities to concentrate on a smaller number of the aggressive transactions. Accordingly, it is submitted that the introduction of safe-harbour rules under the UK tax law may contribute towards an amicable environment for leasing (including cross-border leasing) transactions.

\textsuperscript{529} As in case of the US IRC Sec. 467.
9.3.3. Amendments to the Capital Allowances Act 2001 (UK) in respect of cross-border leases with lessees resident in the other EC Member States

As discussed in chapter 3, in the United Kingdom, the Capital Allowances Act 2001 contains severe restrictive provisions in respect of plant or machinery that is the subject matter of a lease to an overseas lessee, unless the lessee uses the said asset in its business in the United Kingdom. As per the said restrictive provisions, generally, capital allowances are restricted at the rate of 10% instead of the ordinary rate of 25%, whereas the capital allowances are altogether denied in certain situations. For the reasons discussed at chapter 8, it is submitted that the said restrictive provisions of the Capital Allowances Act 2001 violate the freedom to provide services under the EC Treaty. Hence, the said restrictive provisions are incompatible with the EC Treaty.

In order to avoid unwarranted litigation, and with a view to render the Capital Allowances Act 2001 in consonance with the EC Treaty, incorporation of a proviso to the above-mentioned restrictive provision of the Capital Allowances Act 2001 is recommendable. The proviso must exclude applicability of the said restrictive provisions in cases where the lessees are residents of the other EC Member States. Such a proviso would contribute to one of the primary objectives of the European Union, i.e. promoting an internal market characterized by abolition of obstacles to the free movement of services between the Member States.

Such a proviso, besides honouring the United Kingdom’s obligation under the EC Treaty, would also afford a level playing field to lessors from the United Kingdom vis-à-vis lessors from other EC Member States, and thus would facilitate healthy competition between the lessors across the European Union.

9.3.4. Amendments to the group relief regimes under the tax laws of the United Kingdom, Germany and the Netherlands

As discussed in chapter 8, in the early years of a lease, a lessor may incur a tax loss due to the excess of depreciation/capital allowances over the lease rental income. Such a loss would, generally, provide the tax deferral benefit to the lessor, as the lessor may set off the loss against other taxable income.
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Generally, a group relief regime facilitates tax deferral, as a group company with taxable income may be able to claim relief in respect of the tax loss suffered by another group company. However, normally, a group relief regime applies only to resident companies; it does not extend to the losses suffered by a non-resident group company. As a result, a resident group company may not be entitled to make a group relief claim in respect of the losses suffered by a non-resident leasing company within the same group.

The above-mentioned restrictive feature of the group relief regimes may discourage a group from setting up a leasing company in another Member State. Therefore, as argued in detail in chapter 8, the said restrictive features of a group relief regime under the tax law of an EC Member State would violate the EC freedom of establishment (it is observed that the group relief regimes under the tax laws of all three EC Member States examined for the purposes of this research contain this restrictive feature).

With a view to render the group relief regimes under the tax laws of the Member States compliant with the EC Treaty, it is recommendable that the said group relief regimes under tax laws of the EC Member States provide an exception in respect of the losses suffered by the group companies resident in the other Member States. As a result of such exception, by virtue of the group relief regime under the tax law of one Member State, a company resident in that Member State must be allowed to claim the group relief in respect of the losses suffered by a leasing company (within the same group) resident in another Member State.

The above-mentioned modification to the group relief regimes under the tax laws of the EC Member States would not only bring the said regimes in line with the EC Treaty, but it would also reduce unwarranted litigation between corporate groups and the tax authorities.

9.3.5. Strengthening specific anti-avoidance regime under the UK tax law

As discussed at 5.3., in a formalistic legal system (such as the UK legal system), as compared to taxpayers in a substantive legal system (such as the US and the German legal systems), a taxpayer has greater potential to manoeuvre a 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 the general or specific anti-avoidance rules. For in-
stance, in the case of sale-and-finance-leaseback transactions, lessors in the United Kingdom would be in a position to obtain the capital allowances under the Capital Allowances Act 2001, whereas in a comparable transaction, a taxpayer in the United States may not be entitled to depreciation under the IRC as the transaction is likely to be characterized as a “sale” rather than a lease. Accordingly, as compared to the tax authorities in the substantive legal systems, the tax authorities in formalistic legal systems are far more dependent on anti-avoidance rules (general as well as specific) since the legal form of the transaction determines the tax consequences in the absence of an applicable anti-avoidance rule. But, as discussed at 5.2.2., the general anti-avoidance principles emerging from *W.T. Ramsay v. IRC* and subsequent court decisions do not affect the leasing transactions that are not artificial or sham. Therefore, in the United Kingdom, practically, the undue tax advantage in the case of aggressively tax-driven leasing transactions embodying at least some commercial substance may be effectively neutralized only by virtue of an appropriate specific anti-avoidance regime. However, it is observed that the scope of the existing specific anti-avoidance provisions in the UK tax law concerning the aggressive leasing transactions is rather limited as compared to some other tax systems, such as the United States.\textsuperscript{530} Therefore, it is submitted that if the legislature intends to neutralize the tax advantages of aggressively tax-driven transactions, it must strengthen the specific anti-avoidance regime by further incorporating appropriate provisions in the UK tax law.\textsuperscript{531}

530. It is submitted that the aggregate effect of the specific anti-avoidance provisions in the United States (combined with the lease characterization rules) is far more restrictive, as compared to the UK tax law. Under the US IRC, *inter alia*, the income recomputation rules of IRC Sec. 467, the depreciation restrictions in the case of lease of assets to tax-exempt and non-resident lessees, and the loss deduction restrictions in the case of transactions involving non-recourse financing, coupled with the lease characterization on the basis of economic substance of the transaction, strongly impede aggressively tax-driven lease transactions. On the other hand, in the United Kingdom, the Finance Act 1997, Schedule 12, Part 2 only partly neutralizes the tax advantage of a rear-loaded lease transaction, the restrictive capital allowance provisions concerning the overseas leasing are incompatible with the EC Treaty in the case of cross-border leasing transactions involving lessees that are resident in the other EC Member States, and the UK tax law does not contain a counterpart of the US IRC Sec. 465.

531. It must be noted, however, that the said strengthening of the specific anti-avoidance regime must be in respect of the aspects other than the capital allowance entitlement of the UK lessors in respect of leases of assets to lessees resident in the other EC Member States, and entitlement of a UK group company to claim group relief in respect of the losses suffered by a group company resident in another EC Member State.
9.3.6. United Kingdom: Specific restrictive provision concerning interest on non-recourse finance

For the reasons stated at 5.4.5.3.3., under the existing UK tax law, lessors must be granted deduction for interest expenses in respect of non-recourse loans. However, if the legislature seeks to restrict the tax benefits to lessors in respect of the interest expenses on non-recourse loans, then it must introduce appropriate restrictive provisions in the UK tax law.

9.3.7. Inclusion of clarifications in tax treaties: aspects relating to characterization of finance lease income

In view of the magnitude of the amounts involved in big-ticket cross-border finance lease transactions, and the dependence of the applicability of a particular treaty distributive rule upon characterization of the transaction, it is recommendable that tax treaties provide clarifications on the characterization aspects of the finance lease. Such clarifications could be in the form of a protocol to the tax treaty.

For instance, in the case where the domestic tax law of a contracting state characterizes a finance lease as “conditional sale”, it may be desirable to clarify in the protocol to the tax treaty that the said contracting state (in its capacity as a source country) would view a typical finance lease transaction as “conditional sale” and hence the lease rentals under such a transaction would not be treated as “royalties” for tax treaty purposes. Similarly, if the tax treaty contains the version (a) definition of the term “interest”, and since for the reasons given at 6.4.2.4. the finance lease rentals do not constitute “interest”, inclusion of an appropriate clarification in the tax treaty may be recommendable. In such a case, it may be clarified in the protocol to the treaty that no part of the finance lease rentals would be treated as interest income for the treaty purposes. Accordingly, it may also be appropriate to make it explicit in the protocol that the source country taxation of the finance lease rentals would be governed exclusively by the provisions of the “Business profits” article.

It is submitted that if the tax treaties include the aforesaid clarifications on the characterization aspects of finance leases, that would eliminate any potential uncertainty about the tax consequences of the finance lease transac-

532. As discussed at 6.4.2.4.
Recommendations

tions and contribute towards the underlying objective of the tax treaty, i.e. elimination of obstacles to the international exchange of goods, services, capital and technology.
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