Neutrality Matters: Lease Payments by Lessees in Australian Taxation

Christina Allen*

Although Australia's federal income tax rules have gone through several reforms since the beginning of the 20th century, they remain inadequate in several important respects for a 21st century market economy. One key aspect of current deficiencies is that the tax law does not observe the important principle of tax neutrality, whereby similar characterisations of property should not lead to wildly different tax outcomes. Another characteristic is complexity, as it is a sine qua non of tax law that greater complexity is directly related to more tax evasion, greater inefficiency, and eventual failure of specific rules. Both aspects are especially problematic in relation to lease payments in the Australian tax system. This article provides a historical and legal analysis of Australia's tax law, laying out the principles and methods by which tax neutrality and simplicity can be achieved. It shows the inconsistencies in the rules related to leases and how these undermine tax neutrality and how specific rules and misconceived accounting principles create unnecessary complexity in the tax law. These issues can, however, be mitigated, if not entirely resolved, by incorporating the risk-free rate of return into any rule affecting leases and all transactions related to them. The recommendations that follow this approach include adding deferred allowances to the existing capital gains tax regime or a newly implemented capital allowance scheme for lease payments, and removing the loss quarantine rule. Although trade offs between tax neutrality and simplicity may occur in some instances, reforms based on these recommendations will at least be an improvement on the present tax situation in Australia.

I. Introduction

Tax neutrality is an important concept for tax law design which refers to a tax system that does not bias economic decision-making. Central to the attainment of tax neutrality if the accurate measurement of economic gains and losses. The Australian tax system governing consideration paid for leases other than annual rent has long been an ambiguous area according to the concept of tax neutrality. Currently, payment of a lease premium is recognised as a capital loss that can be offset against capital gains at expiry or when assigned before the expiry.[1] If there is no capital gain, payment cannot reduce the payer's taxable income, even if income represents returns on investment.[2] Tax treatment of related payments is similarly inconsistent and confusing. For example, a lease incentive, which reduces the amount of a lease premium, may be immediately assessable or considered a separate asset subject to capital gains tax. Payments for varying or waived terms of a lease, or agreeing to surrender a lease, do not neatly fit into general operations of capital gains tax measures.

In the past, tax depreciation (and the accompanying balancing adjustment) has been suggested as a more appropriate approach to lease payments.[3] However, it is not entirely tax neutral because $1,000 spent

* Curtin Law School, Curtin University. ORCID: 0000-0001-6454-6131.

[1] *Income Tax Assessment Act 1997* (Cth) s 104-25.

[2] In *BP Australia Ltd v Commissioner of Taxation (Cth)* [1966] AC 224, the Privy Council noted that expenses incurred in entering a sales tie were not deductible due to absence of a capital allowance (271) and allowed immediate deduction of the expense upfront: Graeme S Cooper, "Tax Accounting for Deductions" (1998) 5(1) *Australian Tax Forum* 23, 105–106.

[3] Review of Business Taxation (chair, John Ralph), Parliament of Australia, *A Tax System Redesigned – More Certain, Equitable and Durable* (Report, September 1999) Ch 10 (*A Tax System Redesigned*).

today is not the same as $1,000 deductible over multiple years at present value, although it is indeed closer than $1,000 deductible at the end of those years. Depreciation methods are less than precise for accurate measurement of an economic loss in the value of an asset but provide allowable yearly deductions in a mechanical way. Furthermore, historic costs used for depreciation deductions take no account of changing prices over time. Added to this problem is with many intangible assets; duration of intangible assets such as leases can be difficult to predict. Recognising capital losses on a lease that is renewable every five years is as arbitrary as drawing a line between annual rent (of a revenue nature) and a lump sum paid for the right to use property (which is of a capital nature). In other cases, it may be argued that long-term leases should be treated as an acquisition of the underlying property, but this also makes an arbitrary distinction between what may seem reasonable, rather than what is fiscally logical. Therefore, although depreciation measures economic losses more accurately than the current treatment under the capital gains tax regime, it creates a different set of conceptual and practical problems.

In January 2021, the Institute of Fiscal Studies (IFS) has published a report titled *Taxing Work and Investment across Legal Forms: Pathways to Well-designed Taxes* (IFS Report).[4] The report is grounded in earlier work, particularly the Mirrlees Review that identifies tax neutrality, along with progressivity, as integral characteristics for balancing redistribution objectives and incentives to work, which in turn define an effective tax system for an open developed economy in the 21st century.[5] The report advocates cash-based deductions and offers alternative models incorporating the risk-free rate of return to arrive at the tax outcome equivalent to the cash-based deductions. This may be helpful in discovering an appropriate treatment for leases in the Australian tax system for constructing a neutral tax base.

To improve tax neutrality and reduce complexity in the Australian tax system, this article examines the tax treatment of leases. Part II discusses the special lease rules that existed until the mid-1960s that treated costs for the right to use property (such as lease premiums) similarly to regularly paid rent. Part III provides an overview of the current tax treatment of lease-related expenses, revised in the mid-1980s by the introduction of the comprehensive capital gains tax regime. Remarkably, the government has not settled on a principle to distinguish wasting assets from non-wasting assets in the context of intangibles. Consequently, many limited-life intangible assets, including leases, are treated in the same manner as shares, even though, unlike shares, the value of leases inevitably declines over their term. Part IV reviews the recommendations made by the Review of Business Taxation (RBT) in Australia. While the RBT suggests a depreciation regime to treat leases similarly to plant and equipment, its design features are complex to accommodate the artificial recognition of economic losses in the value of a lease. Parts II to IV highlight the lack of tax neutrality embedded in the Australian tax history. With the problems and difficulties of Australian tax history having been considered in the previous parts, Part V of the article examines a conceptual benchmark espoused in the IFS Report, to further explore an appropriate strategy for treating leases. Part VI concludes with the contributions of the article to a growing literature on benchmarking an efficient tax system.

II. The Former Lease Rules

Special rules for the tax treatment of lease-related payments existed from the inception of the federal income tax law in 1915, until 1964. The discussion of how those rules continuously evolved for nearly a half century is helpful to understand various aspects that need to be considered in drafting the tax treatment of leases, herein referred to as "lease rules".

The *Land Tax Assessment Act 1910* (Cth) was the first incarnation of the Commonwealth's tax legislation, enacted nine years after Australia became a federation, to impose taxes on the unimproved value of privately held land. This was intended to encourage the economically efficient use of land and ensure

[4] Stuart Adam and Helen Miller, "Taxing Work and Investment across Legal Forms: Pathways to Well-designed Taxes" (Institute for Fiscal Studies, IFS Report R184, January 2021) (*Taxing Work and Investment across Legal Forms*).

[5] See, especially, conclusions in James Mirrlees et al, "Tax by Design" (Institute for Fiscal Studies, September 2011) Ch 20 (*Tax by Design*). It provides that any deviations must be designed carefully if they can be justified for the goal of minimising economic distortions, such as R&D activities and alcohol/tobacco consumption producing positive and negative externalities, respectively.

even settlement across Australia.[6] This Act treated leasehold estates equivalently to freehold estates, including perpetual leases that required no revaluation and leases with a right to purchase, if they were granted by the Crown, given that the lessees were entitled to receive rents and profits in respect of the land.[7]

However, the federal income tax legislation incepted five years later, in 1915, diverged from this practice to separately acknowledge leases for any leasehold estates used for income-producing activities. In many situations, a lump sum paid on entering a lease to obtain temporary rights to use the property was treated in the same fashion as periodic payments made to similarly occupy the property in reality, while the revenue-capital distinction yielded strikingly different tax outcomes. By assigning a quasi-revenue character to such lump sums calling them "rent substitute" or "commuted rent", the payment that would otherwise not be recognised at all, became deductible for tax purposes.

Accordingly, special rules were drafted to allow taxpayers using premises to generate income, to deduct any premium, fine, foregift, or consideration in the nature of fine, premium, or foregift for a new or renewed lease.[8] The new measure initially utilised the sinking fund, calculating the depreciation based on the amount required to recoup the payment so made, but this was soon replaced by a regulation dividing the sum by the number of years of the unexpired term of a lease.[9] This was different from depreciating an asset based on the number of years determined upfront so that a balancing adjustment was not required every time a change was made to the lease terms. However, money paid to a previous tenant to induce them to vacate the leased premises early was not considered a premium, fine, or foregift, and was thus not deductible.[10]

A balancing adjustment mechanism was available in case of assignment of leases – that is, subleasing that transferred the tenancy of a lease either temporarily or until the end of the lease by creating new rights and obligations.[11] This was a two-step process to, first, treat subleases in substantially the same manner as leases to include the transfer value assessable income of the lessee[12] (which was subsequently deductible to the sublessee[13]). Afterwards, the assessable income was reduced by a portion of any fine, premium, or foregift attributable to the unexpired term of the head lease. However, this could no longer be deducted by the lessee, but was deductible by the sublessee upon entering the subleasing arrangement. The assessable income was also reduced by any amount paid by the lessee, for example, to the lessor, for the assignment or transfer of a lease. In effect, when there was income that could be offset in respect of a sublease, that amount was assumed to be attributable to the unexpired term of the head lease.

These rules went through various changes because, at that time, the tax law did not impose any tax on capital gains. It was necessary to remove any gains or losses realised from disposing a business asset (eg, machinery[14]) from the transfer value included in assessable income.[15] This, was not, however,

[6] This tax system used progressive tax rates with a tax-free threshold to penalise private holdings of large land masses without conducting any economic activities. It was ultimately abolished in 1952 and since then, land taxes have been collected at State or local levels only. In the same year, State income tax systems were abolished and currently, income tax is collected at the federal level only.

[7] *Land Tax Assessment Act 1910* (Cth) ss 3 (definition of "owner"), 25–29.

[8] *Income Tax Assessment Act 1915* (Cth) s 20(i). This provision was rewritten in 1922: see *Income Tax Assessment Act 1922* (Cth) s 23 (the *1922 Act*). In *JC Williamson's Tivoli Vaudeville Pty Ltd v Commissioner of Taxation (Cth)* (1929) 42 CLR 452, which considered the *1922 Act*, it was confirmed that a premium, etc. could be made in specie.

[9] *Income Tax Assessment Act 1918* (Cth) s 16(e).

[10] In reference to the legislation, such a payment is not in the nature of a premium, fine or foregift: see *Clarke v Commissioner of Taxation (Cth)* (1932) 48 CLR 56, 75.

[11] By *Income Tax Assessment (No 2) Act 1916* (Cth) s 5(b).

[12] In the original legislation, the assessable amount was originally "any payment", which was changed to "money" in 1922. Subsequently, in *Messer v Deputy Commissioner of Taxation (Cth)* (1934) 51 CLR 472 it was held that consideration paid in the form of shares was not assessable income.

[13] See *Income Tax Assessment (No 2) Act 1916* (Cth) s 12(b).

[14] Machinery was explicitly listed in *Income Tax Assessment Act 1915* (Cth) s 20(i).

[15] This was applied in *Dalrymple v Commissioner of Taxation (Cth)* (1924) 34 CLR 283.

accomplished without a trial and error period. It became apparent that some hotel businesses were exploiting the change to claim a tax exemption by shifting the value of a sublease to goodwill.[16] To close this loophole, the term "asset" was changed to "tangible assets" when the lease provision was rewritten in 1922.[17] However, the High Court later held that tangible assets included leases (not only assets such as machinery) on the grounds that every lease had a real and substantial value of tangible leased property.[18] This meant that subleasing would never be included as assessable income. The defect was initially repaired when the government abolished the assessment rule for gains arising from subleases[19] in anticipation of passing the proposed *Lessee Tax Bill 1924* (Cth)[20] to separately impose taxes. However, the Bill died in the Senate. When the assessment rule was reinstated six years later, a variety of scenarios that could arise from leasing or subleasing arrangements were considered to allow deductions for expenses that had not yet been claimed in respect of the grant, assignment, or transfer of a lease.[21] Furthermore, any amount paid to surrender a lease was added to complete the balancing adjustment process, while the lessor would have been assessed on the receipt in the nature of a fine.[22] The deduction provision allowed deductions for lease payments within the period that assessable income was generated.[23]

More perplexing features of the lease rule arose from the tension between leases and other types of capital assets. The structure of the income tax legislation was such that the costs of capital assets were not deductible unless otherwise specified (eg, depreciable plant and equipment). However, the method of distinguishing leases from capital assets that were not subject to tax assessment was greatly influenced by whether leases were, in substance, akin to the conveyance of underlying tangible property. From a tax policy perspective, a question could be raised about which leases are equivalent to the outright acquisition of leased property and, more importantly, the rationale by which payments for such leases should for tax purposes be treated differently from other leases. For example, costs incurred in acquiring land that generally appreciates in value are expected to be returned. However, the design feature of the lease rule that carved out conveyance equivalents was primarily determined by the duration of a lease. While it is true that a holding period is often a feature of acquisition, the lease rule did not interrogate whether costs would be recoverable on the cessation of a lease. Considering remarkably different tax outcomes between standard leases and leases that were equivalent to conveyances (for payment paid upfront in both cases), the period given to recognise costs should be revisited to design a neutral tax system. While the other side of the world, especially the United States, was exploring new options with notable attention to expenditure taxation, the Australian lease rule evolved in a familiar fashion to set boundaries to prevent certain types of leases from allowing deductions, on the basis that they should be characterised as conveyances.

The following modifications are worth noting. In 1924, to distinguish deductible expenses from any moneys effectively paid for acquisition of underlying property, perpetual leases that did not require

[16] See, eg, Commonwealth, *Parliamentary Debates*, House of Representatives, 10 October 1922, 3476–3477 (Stanley Melbourne Bruce, Treasurer).

[17] *Income Tax Assessment Act 1922* (Cth) s 16(d).

[18] *Legh v Commissioner of Taxation (Cth)* (1926) 38 CLR 252, which considered the sale of a pastoral business that included a government lease. After the decision, many taxpayers sought to amend their tax returns. The Commissioner provided refunds at the rate applicable to income from property or at the rate applicable to income from personal exertion where a profit-making scheme could be established: see Commissioner of Taxation, Parliament of Australia, *Tenth Report of the Commissioner of Taxation: Years 1923–24, 1924–25 and 1925–26* (March 1927) 16. Note the different tax rates that applied to income from property and income from personal exertion; however, this distinction became less relevant, as the penalty rate applicable to income from property was removed in 1953.

[19] By *Income Tax Assessment Act 1924* (Cth) s 4(k).

[20] *Lessee Tax Bill 1924* (Cth) (introduced on 1 October 1924); *Lessee Tax Bill (No 2) 1924* (Cth) (introduced on 9 October 1924). The Bills were intended to "impose a tax upon lessees in respect of certain payments received by them for, upon or in consideration of, the assignment or transfer of leases".

[21] See *Income Tax Assessment Act 1930* (Cth) s 6(f).

[22] *Income Tax Assessment Act 1930* (Cth) s 6(f); *Income Tax Assessment Act 1936* (Cth) s 85.

[23] *Income Tax Assessment Act 1930* (Cth) s 12(c).

revaluation, or which carried a right to purchase, were excluded from the lease rule.[24] Those leases were assumed to transfer ownership of land, as with the acquisition of freehold estates in the *Land Tax Assessment Act 1910* (Cth). In 1952, this exclusion was modified to include any lease granted in perpetuity or for a term of no less than 99 years.[25] It was acknowledged that, in effect, any business lease granted for 99 years in the Australian Capital Territory was equivalent to a conveyance of the premises.[26]

In 1936, Crown leases used for primary production were also removed, because acquiring that kind of lease was deemed to be equivalent to acquiring Crown land, where a transition rule allowed deductions in respect of any gain made from assigning or transferring a pre-1936 lease.[27] Then, in 1954, due to concerns that taxation might interfere with land transactions for potential mining sites,[28] leases granted for mining purposes were excluded unless both parties to a lease transaction agreed to apply the statutory lease rules.[29]

Notably, in relation to indefinite leases that provide tenancies at will, month-to-month leases or year-to-year leases, the end date of a lease period is usually unknown. Nonetheless, while the lessor's income was assessed on the full value of a premium received for an indefinite lease, the lessee was not able to claim a deduction for paying the premium because there was no end date from which to calculate the residual value of the lease. This was considered inappropriate so, in 1952, steps were taken to allow deductions for the costs of entering indefinite leases. To allow these deductions, indefinite leases were deemed to last for two years, which was because lessors were allowed a tax rate adjustment in respect of any lease lasting for 25 months or more.[30] The assigned period was entirely arbitrary, exemplifying the difficulty of designing capital allowances for leases that vary their terms in myriad ways.

By contrast, absolute assignment of leases – that is, complete transfer of rights or benefits to another party – took a different path. Although such a transaction is equivalent to a property conveyance, it was argued that absolute assignments of leases should remain in the lease rule because owners of freehold estates were assessed on consideration received for granting a lease.[31] This was necessary to ensure that balancing adjustment was consistent with ordinary assignments of leases.

Other than the distinction from conveyances, the intangible nature of assets makes characterisation prone to mislabelling. Notable assets that can shift with the value of leases are goodwill and licences related to a business carried on leased premises.[32] While relabelling such goodwill or licences as leases enabled their transfer value to be deductible, there was no precise way of distinguishing between them. This dilemma caused back-and-forth amendments to the lease rule. In 1930, goodwill and licences attached to the land were included in the rule to treat them in the same manner as leases.[33] Thus, it was held that the value of goodwill depended on location (referred to as "local goodwill") and licences attached to

[24] *Income Tax Assessment Act 1924* (Cth) s 10.

[25] *Income Tax and Social Services Contribution Assessment (No 2) Act 1952* (Cth) s 11.

[26] Commonwealth Committee on Taxation (chair, ES Spooner; acting chair, SB Holder), *Reports on Leases* (Reference No 17, January; July 1952) [14]–[22] (*Reports on Leases*).

[27] *Income Tax Assessment Act 1936* (Cth) s 88A, as inserted by *Income Tax Assessment Act (No 2) 1936* (Cth) s 14.

[28] See Commonwealth, *Parliamentary Debates*, House of Representatives, 2 September 1954, 884 (Arthur Fadden, Treasurer).

[29] *Income Tax Assessment Act 1936* (Cth) s 88B, as inserted by *Income Tax and Social Services Contribution Assessment Act 1954* (Cth) s 10. It required an election lodged in authorised form: see *ICI Alkali (Australia) Pty Ltd v Commissioner of Taxation (Cth)* (1978) 53 ALJR 220. See further JA Timbs, "Historical Survey of the Mining Provisions of Commonwealth Income Tax Legislation" in Taxation Review Committee (chair, KW Asprey), *Full Report*, Parl Paper No 136 (May 1975); Christina Allen, "Statutory Depreciation Regimes for Intangible Assets" (2021) 36(1) *Australian Tax Forum*, forthcoming.

[30] *Income Tax and Social Services Contribution Assessment (No 2) Act 1952* ss 9–10. It was recommended in *Reports on Leases*, n 26, [8].

[31] *Royal Commission on Taxation* (chair, David Gilbert Ferguson) (Third Report, January 1934) [741]–[749].

[32] Some hotel business owners, especially those in Queensland and Victoria, had been using to avoid tax by value shifting between lease premiums, goodwill and licences: see Explanatory Notes on Amendments, *Income Tax Assessment Bill 1930* (Cth) 26–27.

[33] *Income Tax Assessment Act 1930* (Cth) s 6(f).

the land were indistinguishable from the value of the premises.[34] However, separating local goodwill from "personal goodwill" – that is, goodwill that is personal to a specific professional person, such as a medical practitioner and therefore independent of the leased premises and could not be treated as rent[35] – posed another difficulty, as evidenced by continuing litigation.[36] After 22 years of having goodwill and licences in the lease rules, all references to these elements were excised from the lease rules in 1952.[37]

From the perspective of revenue raising, including goodwill and licences in the lease rule appeared meaningless, pursuant to the principle that "whatever amount may be [an] allowable deduction to one party to the lease, the same amount should be included in the assessable income of the other party",[38] although the timing of assessing income related to leases was never precisely symmetrical (eg, immediate assessment of lease premiums).[39] Interestingly, this also held true if the lease rule were to be removed from the tax legislation entirely. This was noted by the tax review committee in the early 1960s; however, the committee conceded that, because the lease rules had been deeply rooted in the federal income tax system since its inception, these rules were now a structural part of the law.[40] The committee did not suggest abolishment of the lease rule in any sense, but the government in 1964 took a different path and finally removed the complex rules that governed lease transactions.[41] Although deductions ceased, a new provision was subsequently legislated to continue bringing in lease premiums as assessable income.[42]

Overall, complexity was one of the main factors in the failure of the former lease rule. The goal of recognising lump sums paid for the rights to use property in a manner consistent with rent paid for similar economic use of property was subsequently challenged because of inconsistent treatment between leases and other capital assets that were not subject to tax assessment. The natural assumption, then, is that

[34] *Royal Commission on Taxation*, n 31, [751]–[752]. The distinction between local goodwill and personal goodwill was applied in *Phillips v Commissioner of Taxation (Cth)* (1947) 75 CLR 332 in which it was found that goodwill was independent of a news agency business carried on at the leased premises.

[35] *Royal Commission on Taxation*, n 31, [752].

[36] The *Reports on Leases*, n 26 noted that characterisation ambiguities remained even after 27 cases decided by the High Court and the Boards of Review between 1946 and 1952. See, eg, *Daniell v Commissioner of Taxation (Cth)* (1928) 42 CLR 296 (reassessable premiums); *Commissioner of Taxation (Cth) v Williamson* (1943) 67 CLR 561 (redeductible goodwill attached to the leasehold of a chemist business); *Phillips v Commissioner of Taxation (Cth)* (1947) 75 CLR 332 (re non-assessable goodwill); *Box v Commissioner of Taxation (Cth)* (1952) 86 CLR 387 (re non-assessable goodwill); *Commissioner of Taxation (Cth) v Smith* (1952) 9 ATD 456 (re non-assessable goodwill); *Commissioner of Taxation (Cth) v Watson v* (1953) 87 CLR 353 (reassessable goodwill); *Berry v Commissioner of Taxation* (1953) 89 CLR 653 (re non-assessable covenant/goodwill); and *Commissioner of Taxation (Cth) v Connolly* (1953) 90 CLR 483 (reassessable covenant/goodwill).

[37] *Income Tax and Social Services Contribution Assessment (No 3) Act 1952* (Cth) ss 15–16. It was recommended in *Reports on Leases*, n 26.

[38] As noted in Commonwealth Committee on Taxation (chair, GC Ligertwood), *Report of the Commonwealth Committee on Taxation* (Reference No 100, June 1961) [265] (*Report of the Commonwealth Committee on Taxation*); *Reports on Leases*, n 26, [31].

[39] Gains received by lessors related to the creation of a lease in the form of a bonus, premium, fine or foregift were immediately assessed as income: *Income Tax Assessment Act 1915* (Cth) s 14(d); *Income Tax Assessment Act 1922* (Cth) s 16(d); *Income Tax Assessment Act 1936* (Cth) s 84. Since the *Royal Commission on Taxation*, n 31, recommended revising the progressive tax rate that applied to large premiums because the landlord might be pushed to a higher tax bracket ([753]–[757]), the government introduced a new rule to smoothen the marginal tax rate effect in *Income Tax Assessment Act 1936* (Cth) s 86; see examples in Explanatory Memorandum, *Income Tax Assessment Bill 1935* (Cth) 101.

[40] *Report of the Commonwealth Committee on Taxation*, n 38, [264]. The committee had suggested that, to capture any rent substitute or commuted rent, goodwill and licences, as well as other assets, be reinstated in the lease rules if those assets were attributable to leased premises: [338]–[342].

[41] In 1964, the Division for leases was removed by *Income Tax and Social Services Contribution Assessment Act (No 3) 1964* (Cth) by inserting s 83AA in the *Income Tax Assessment Act 1936* (Cth). Transitional measures in relation to Crown leases used for primary production and mining leases were terminated by *Income Tax Assessment Act (No 2) 1968* (Cth), amending *Income Tax Assessment Act 1936* (Cth) ss 83AA, 88B.

[42] *Income Tax and Social Services Contribution Assessment Act (No 3) 1964* (Cth) s 9, which inserted s 26AB in the *Income Tax Assessment Act 1936* (Cth). From 1985, the inserted provision operated in parallel with capital gains tax rules until abolished in 1997.

treating all capital assets on the same grounds would reduce complexity. However, the next part tells a different story – to wit that this option is also not as simple as it seems.

III. Under Capital Gains Tax Measures

After two decades of deductibility of capital expenses related to leases being passed over, an opportunity arose for reducing income derived wholly or in part from incurring said expenses. Specifically, comprehensive capital gains measures, introduced in 1986, recognised leases as assets from which gains or losses are subject to tax.[43] However, interpretative difficulty arose from the definition of an asset because a bundle of rights over land can be treated as a lease or something else like ownership, while the commencement date of the measures further complicated determination of whether a lease should be subject to tax. Differences in interpretation have affected tax neutrality. Moreover, the deferred tax treatment of cost elements of an asset under the measures makes the tax system further deviate from tax neutrality.

Assets recognised under these measures, later called "CGT assets", included a broad range of intangible assets, including goodwill.[44] Thus, in the absence of a general capital allowance regime for intangible assets (except a few assets such as patents that were specifically allowed to depreciate[45]), many intangible assets fell within the scope of capital gains tax. The requirement to identify an asset was of first importance and, to some extent, eliminated the incentive to relabel disposal of property as leasing. For example, in line with the traditional view, leases granted either in perpetuity or for 99 years or more were initially deemed to be conveyances of the land, which is how they had been regarded under the old lease rules.[46] These were later modified to remove inconsistencies arising from the definition of perpetual leases in differing laws of each specific State or Territory so that only leases granted for a term of 99 years or more were viewed as disposal,[47] which is the current law. However, practical differences in tax outcomes are questionable because a lease premium paid upfront would be recognised upon expiry in the same way as an acquisition cost recognisable upon disposal.

The recognition of various rights created different problems that complicated the tax treatment of leases. One of the driving forces behind these complications is the commencement date of capital gains tax – 20 September 1985. Ideally, capital gains tax would apply to gains accrued (and losses occasioned) from the commencement date. However, before releasing draft legislation, the government was warned about the political risks associated with this approach of failing to pass the Bill and subsequently revised it to introduce capital gains tax only for assets acquired from the commencement date.[48] "Land" was defined as any interest, right or power related to land, including any privilege thereto or connection with the land, and included any improvement, building, or structure on it. However, under capital gains tax rules,[49] it was possible for taxpayers to avoid tax by claiming the grant of a lease as a disposal of land acquired before 20 September 1985. To overcome this anomaly, a special set of rules were inserted into

[43] By *Income Tax Assessment Amendment (Capital Gains) Act 1986* (Cth).

[44] *Income Tax Assessment Act 1936* (Cth) s 160A; *Income Tax Assessment Act 1997* (Cth) s 108-5. Slater argues that goodwill is not property but "a quality or attribute": in AH Slater, "Nature of Goodwill" (1995) 24(1) *Australian Tax Review* 31. However, this view has no bearing on the application of capital gains measures: see, eg, *Commissioner of Taxation (Cth) v Murry* (1998) 193 CLR 605, [29]; [1998] HCA 42.

[45] The current list of intangible assets included in "depreciating assets" can be found in *Income Tax Assessment Act 1997* (Cth) s 40-30(2).

[46] Under *Income Tax Assessment Act 1936* (Cth) s 160Z(9)(d), the disposal of a lease granted in perpetuity or for a term not less than 99 years not only created a capital gain but could also create a capital loss.

[47] In *Wilson v Anderson* (2002) 213 CLR 401; [2002] HCA 29, the High Court stated that a lease in perpetuity was a creature of statute forming part of the special regime governing Crown land: 450. This view was endorsed and applied to tax law in *Watson v Deputy Commissioner of Taxation (Cth)* (2008) 171 FCR 77, 89–90; [2008] FCA 1173. The reference to leases granted in perpetuity was removed when the relevant provision was rewritten in the *Income Tax Assessment Act 1997* (Cth) s 118-40.

[48] *Income Tax Assessment Act 1936* (Cth) s 160L; *Income Tax Assessment Act 1997* (Cth) Div 104.

[49] *Income Tax Assessment Act 1936* (Cth) ss 160K, 160P; *Income Tax Assessment Act 1997* (Cth) ss 108-5, 108-70.

the legislation, where all leases were classified as individual assets,[50] with subleases classified as assets separate from their head leases.[51]

The commencement date also led to the insertion of special rules for reversionary interests – that is, rights that a property owner (the lessor) retains under a lease.[52] Specifically, these rules apply to a situation where a lessee of property acquires the lessor's reversionary interest following the cessation of a lease, for which it is necessary to establish the cost base of the reversionary interest. The special rules deem that, if the lease was granted before 20 September 1985, the cost base of a reversionary interest is the market value of the lease when it expires. If leasing represents a disposal of property (in the case of perpetual leases), the lease and the reversionary interest are considered as one whole – that is, a composite asset. This means that the reversionary interest is deemed to have been acquired at the acquisition time of the lease. That way, for permanent leases granted before 20 September 1985, any gain arising from disposing of a reversionary interest can be disregarded for the purpose of capital gains tax. If a permanent lease was acquired on or after 20 September 1985, the costs are included in the cost base of a reversionary interest.

The second factor is a broad range of assets recognisable under the capital gains tax regime. Previously, lease-related costs such as a fine, premium, foregift and consideration in the nature of a fine, premium, or foregift were included or excluded from the remaining value of a lease, which was then divided by the remaining number of years left in the lease. The mechanics of recognising lease-related costs are different for capital gains tax. The cost base comprises five elements: (1) acquisition costs; (2) incidental costs to acquisition (other than costs incurred in preparing, registering, or stamping a lease or assigning or surrendering a lease, which are separately deductible[53]); (3) costs related to ownership; (4) costs to increase or preserve the value of an asset; and (5) costs to preserve or defend the title or rights to an asset.[54] These costs are recognised at disposal.[55] Disposal, in the context of an intangible asset like a lease, can be called cancellation, release, discharge, satisfaction, surrender, forfeiture, expiry or abandonment.[56] If a taxpayer has a capital gain against which the declined value of a lease can be offset, a net amount is included in assessable income.[57] If not, the capital loss is carried forward to be offset against a future capital gain. Thus, it has the potential to never reduce the assessable income produced using the lease.

[50] *Income Tax Assessment Act 1936* (Cth) Div 5. This approach was not new, as the High Court had previously considered this in *Commissioner of Taxes (Q) v Camphin* (1937) 57 CLR 127, 133–134, which was referred to in the context of capital gains tax in *Allina Pty Ltd v Commissioner of Taxation (Cth)* (1991) 28 FCR 203, 210.

[51] *Income Tax Assessment Act 1936* (Cth) s 160ZR.

[52] *Income Tax Assessment Act 1936* (Cth) s 160ZW; *Income Tax Assessment Act 1997* (Cth) s 132-15.

[53] At present, the costs for lease documentation are immediately deductible under the *Income Tax Assessment Act 1997* (Cth) s 25-20. There was a similar provision in the *Income Tax Assessment Act 1936* (Cth) s 68, which was inserted in 1963 and substituted in 1984 before the introduction of capital gains tax in 1986 and the last resort deduction regime in 2001.

[54] *Income Tax Assessment Act 1936* (Cth) s 160ZH; *Income Tax Assessment Act 1997* (Cth) s 110-25. The government included interest expenses on money borrowed for an asset acquired after 20 August 1991 (*Income Tax Assessment Act 1936* (Cth) s 160ZH(6A)) and in 1997, interest expenses on money borrowed for refinancing or enhancing the value of an asset as well as rates and land taxes (*Income Tax Assessment Act 1997* (Cth) s 110-55(2)) in case the court characterised certain interest expenses as having a capital nature.

[55] *Income Tax Assessment Act 1936* (Cth) s 160L; *Income Tax Assessment Act 1997* (Cth) s 104-10 (CGT event A1). If it not used for income-producing purposes, a capital loss is disregarded to prevent deductions of property that is for personal use. Initially, a lease had to be used "wholly or principally" for income-producing purposes under *Income Tax Assessment Act 1936* (Cth) s 160Z(9)(d). This was modified to "solely or mainly" in 1997: see *Income Tax Assessment Act 1997* (Cth) s 118-40. Similarly, capital gains tax is triggered when a transferor becomes a tenant in common with other joint venture participants: see *Taras Nominees Pty Ltd v Federal Commissioner of Taxation* (2015) 228 FCR 418; [2015] FCAFC 4; *Kafataris v Federal Commissioner of Taxation* (2015) 243 FCR 291; [2015] FCA 874.

[56] *Income Tax Assessment Act 1936* (Cth) s 160M; *Income Tax Assessment Act 1997* (Cth) s 104-25 (CGT event C2). In *Commissioner of Taxation (Cth) v Orica Ltd* (1998) 194 CLR 500; [1998] HCA 33, Gummow J stated (543): "Each of the steps … is apt to identify supervening activity by the disponor (for example, by surrendering a lease or permitting it to expire without the exercise of a right of renewal or continuation) or by a third party exercising some superior authority (for example, by forfeiting a lease, redeeming a debenture or cancelling a share) which extinguishes the asset in question."

[57] *Income Tax Assessment Act 1936* (Cth) s 160ZC; *Income Tax Assessment Act 1997* (Cth) s 102-5.

Whether paid in money or in the form of in-specie consideration, a lease premium paid upfront is undoubtedly a first element of the cost base. Rights that can be labelled independently of a lease may not be included in the cost base of a lease, even though those rights affect other rights under a lease. At the time of entering a lease, a lessor may pay an incentive to its lessee with the effect of increasing money payable by the lessee. A lease incentive is recognised as a separate asset that results in an immediately assessable capital gain, rather than reducing the cost base of a lease entered by the lessee.[58] Assume a 10-year lease costing $1.5 million payable upfront over 10 years. The transfer of the costs can alternatively be structured as $2 million paid upfront and $0.5 million immediately returned to the lessee. In the former, the $1.5 million would be deductible at the end of the 10-year period, whereas, in the latter, the lessee must recognise income of $0.5 million immediately and deduct $2 million at the expiry of the lease.

In the past, the judicial characterisation of lease incentives has been inconsistent. In some cases, lease incentives were characterised as income on the grounds that moving premises is part of business activities or making a profit in a commercial sense.[59] In other instances, payment received for a fit-out was considered a capital receipt despite the fit-out being uncovenanted improvements with no guarantee of benefits to the lessor[60] (unlike covenanted improvements that lessors can rent out or sell the premises at a higher price[61]). While the receipt is assessable upfront either way, this distinction is important if there is a capital loss that can be offset.

In certain situations, a lessee may pay or receive consideration for varying or waiving the terms of a lease. As was the case under the former lease rules, such payments are added to the cost base of a lease, typically as a fourth element of the cost base, although tax treatment of receipts was unclear under the former lease rules. One possible treatment is that changes in the rights under a lease create new rights to be considered as an independent asset. Alternatively, a special rule can be drafted to treat receipts consistently without seeking an independent asset. The latter was chosen at the introduction of capital gains tax, allowing lessees to reduce the tax base of a lease by any amount received for having agreed with varied or waived lease terms, and any amount over the full recovery of the cost base is assessed as a capital gain.[62]

Another similar transaction is consideration received by a lessee for agreeing to surrendering a lease when a lessor comes across an opportunity to grant a new lease on more favourable terms. In this case,

---

[58] *Income Tax Assessment Act 1997* (Cth) s 104-35 (CGT event D1); Hope Ashiabor, "Lease Incentive Payments and Capital Gains Tax Provisions" (1999) 2(2) *Journal of Australian Taxation* 102. If incentives are characterised as income, capital gains measures do not apply by *Income Tax Assessment Act 1997* (Cth) s 118-2.

[59] *Commissioner of Taxation (Cth) v Cooling* (1990) 22 FCR 42; similarly, *Commissioner of Taxation (Cth) v Montgomery* (1999) 198 CLR 639; [1999] HCA 34; *O'Connell v Commissioner of Taxation (Cth)* (2002) 121 FCR 562; [2002] FCA 904. Subsequent to the first-mentioned case, the ATO released Taxation Ruling IT 2631 (*Income Tax: Lease Incentives*) in 1991. The doubt casted about judicial characterisation is illustrated in Justin Dabner, "Lease Incentives and the Gain Theory of Income" (1998) 1(2) *Journal of Australian Taxation* 136; Hope Ashiabor, "Lease Incentives: Disentangling the Myer Web" (1998) 2(2) *Tax Specialist* 73; Neil Bellamy and Stephen Barkoczy, "When Will Lease Incentives Be of an Income Nature?" (1998) 1(1) *Journal of Australian Taxation* 14; Domenic Carbone, "An Extraordinary Concept of Ordinary Income? The Significance of Federal Commissioner of Taxation v Montgomery on What Is Income According to Ordinary Concepts" (2010) 20(1) *Revenue Law Journal* 1; AH Slater, "Revenue v Capital: A New Direction, or Back to the Future?" (2016) 45(1) *Australian Tax Rev* 6. Notably, Australian courts hold that isolated or extraordinary transactions can give arise to assessable income: see, eg, *Commissioner of Taxation v Myer Emporium Ltd* (1987) 163 CLR 199; *Commissioner of Taxation (Cth) v Whitfords Beach Pty Ltd* (1982) 150 CLR 355. Pagone noted, "[T]he circumstance of the capital having remained intact may be sufficient to provide the finding that the receipt had the character of income without the need to find that the circumstances of the receipt had the characteristics of income-earning activity.": GT Pagone, "Tax Uncertainty" (2009) 33 *Melbourne University Law Review* 886, 895.

[60] *Selleck v Commissioner of Taxation (Cth)* (1997) 78 FCR 102.

[61] Ironically, in *Lees & Leech Pty Ltd v Commissioner of Taxation (Cth)* (1997) 73 FCR 136, the court held that a lessee appeared to derive no gain when the lessor paid the lessee for covenanted leasehold improvements. However, the court also declined to characterise the gain and remitted the matter to the tribunal for it to determine whether there was a gain.

[62] See *Income Tax Assessment Act 1936* (Cth) ss 160ZT(1)(b), 160ZT(2)(a); *Income Tax Assessment Act 1936* (Cth) ss 104-125 (CGT event F4), 132-1.

the event constitutes disposal of a lease, so the consideration is likely to be considered capital proceeds.[63] If not, the receipt may nevertheless separately create a capital gain by reason of ending rights held.[64] That said, similar to lease incentives, consideration for surrendering a lease has been subject to a judicial distinction of characterising revenue or capital expenses with inconsistent outcomes.[65]

The final factor is an obvious one: deferred recognition of costs related to a lease. Previously, all taxpayers were allowed to index costs related to property that was owned for at least 12 months and calculated through the Consumer Price Index (CPI).[66] This was replaced in 1999 with a partial exemption on gains for individuals and superannuation.[67] However, capital losses have been never eligible for these cost uplift measures, which means that the cost base of leases can never be adjusted for inflation when the taxpayer claims a decline in value. Also, the partial exemption does not apply to gains arising from lease transactions.

Deferred cost recognition is particularly troublesome for long-term leases. In the case of mining leases, the government generally allows capital allowances rules, subject to transition measures, to encourage and assist exploring, prospecting and mining operations.[68] Contrarily, in 1989, the government introduced a special rule concerning leases granted for at least 50 years, called "long-term leases", on the basis that lessors would be assessed on a large premium proportional to the value of the underlying property, less only a fraction of the cost incidental to the lease transaction.[69] Taxpayers were given the option to treat the grant of a long-term lease as a disposal of the leased property. Later, when selling property after the end of a lease, the seller (the lessor) would be assessed on the disposal of the property without the acquisition cost as its cost base. However, any amount paid to the lessee to vary or waive a lease term, plus any transactional costs, were included in the cost base. Furthermore, any payment received during the lease was considered a capital gain. This rule applies equally to situations of subleasing to reduce the assessable receipt by costs attributable to a head lease, hence adding unnecessary complexity and inconsistency on an arbitrary basis to tax rules governing leases.

Since then, the government has introduced capital gains exemption rules for active business assets in small businesses.[70] Nonetheless, it remains unclear how these may be applied to safeguard legitimate

---

[63] *Income Tax Assessment Act 1936* (Cth) s 160ZD; *Income Tax Assessment Act 1997* (Cth) s 116-20.

[64] In Taxation Ruling TR 2005/6 (*Income Tax: Lease Surrender Receipts and Payments*), the Commissioner stated that a deemed disposition may apply under *Income Tax Assessment Act 1997* (Cth) s 104-25. The policy intent of this provision is to capture the capital gain from creating a new asset, rather than to recognise a capital loss. It seems strange to treat a surrender as a transfer of a lease from the lessee to the lessor for applying the deemed disposition because the provision essentially deems the surrender, but not a transfer, to be a disposition.

[65] In *Rotherwood Pty Ltd v Commissioner of Taxation (Cth)* (1996) 64 FCR 313, the payment received by the lessee upon the surrendering of a lease had a revenue nature. In contrast, the court considered the payment as having a capital nature in *Kennedy Holdings & Property Management Pty Ltd v Commissioner of Taxation (Cth)* (1992) 39 FCR 495, 501. The author is unaware of a case where the payment was considered a revenue expense.

[66] *Income Tax Assessment Act 1936* (Cth) ss 160X(6), 160ZJ; *Income Tax Assessment Act 1997* (Cth) s 110-36, Div 114.

[67] *Income Tax Assessment Act 1997* (Cth) Div 115 (especially ss 115-25, 115-100).

[68] See *Income Tax Assessment Act 1997* (Cth) s 40-30(2)(a), which was applied in *Mitsui and Co (Australia) Ltd v Federal Commissioner of Taxation (Cth)* (2011) 86 ATR 258; [2011] FCA 1423. The transitional measure can be found in *Income Tax (Transitional Provisions) Act 1997* (Cth) s 40-77(4) in relation to the redundant *Income Tax Assessment Act 1997* (Cth) Div 330, which mandates that capital gains measures apply to mining leases acquired before 2001 because the previous depreciation rules were made redundant following the introduction of the uniform capital allowance regime.

[69] *Income Tax Assessment Act 1936* (Cth) s 160ZSA, as inserted by *Taxation Laws Amendment Act (No 4) 1989* (Cth); *Income Tax Assessment Act 1997* (Cth) ss 104-115, 132-10.

[70] At present, there are four small business concessions available under the *Income Tax Assessment Act 1997* (Cth) Div 328. The first concession allows a 50% exemption on capital gains, which operates on top of the 50% exemption applicable to cost adjustment. This results in a 75% exemption on gains for eligible taxpayers. Two other concessions, introduced in 1997 and 2001, respectively, provide a complete tax exemption on capital gains to assist with retirement savings. The last, also introduced in 1997, enables taxpayers to defer capital gains when the proceeds are used to invest in a subsequent business. Generally speaking, these concessions have limited application to lessors who make income from owning property or a lease, as the property or a lease must be an "active business asset". These concessions are also unlikely to apply to leasing enterprises, as their business value must exceed the maximum threshold if they are to be qualified as a small business.

claims in relation to leases and other intangible assets (eg, goodwill and licences) connected to an active business.[71] Overall, various products yielded from the mechanics of capital gains tax show the asset-by-asset assessment has served only to create different complexities, with the tax neutrality goal further distant.

IV. Review of Business Taxation (RBT): A Proposal of Capital Allowances

The RBT, undertaken more than two decades ago, is significant because it was the last review which the Australian Government considered for potential tax reform of lease-related rules. It suggested a combination of immediate deductions and depreciation to step away from the deferred deductions presently allowed under the capital gains tax regime. Although this recommendation was not implemented, the design features are worth a look.

The RBT was a comprehensive business tax review conducted in the late 1990s to find ways to increase the competitiveness and efficiency of Australian businesses.[72] The review was chaired by a businessman, John Ralph, and its final report titled *A Tax System Redesigned* was released in 1999. This report was accompanied by draft legislation that proposed a new structural framework for working out taxable income – namely, the Tax Value Method (TVM).[73] The TVM was said to be *principle-based* and, on that basis, promised to bring the benefits of simplicity and certainty.[74] However, the TVM mainly adhered to accounting concepts such as income and expenses, with their inherent shortcomings in practice when it came to accurately valuating all assets and liabilities on hand at balance dates.[75] Accounting principles are based on accruals and, to measure accrued income, valuation must be marked to market, which is difficult, if not impossible. Besides, accounting adopts a categorical approach in distinguishing depreciable wasting assets and non-wasting assets subject to revaluation, particularly in the context of leases, financial leases, and operating leases.[76] Steeped in this discipline, the report claimed that capital allowances for wasting assets, distinguishable from non-wasting assets, were central to taxing investment income.[77]

Lacking a single focus, recommendations in the report were highly selective. For example, amortisation of goodwill was set aside for consideration of revenue neutrality,[78] while one 38-page chapter was

[71] See, eg, *Commissioner of Taxation (Cth) v Krakos Investments Pty Ltd* (1995) 61 FCR 489, which considered a dispute in relation to the allocation of the value between goodwill and a lease premium. Similarly, value was attempted to be assigned to goodwill in the sale of a taxi licence in *Commissioner of Taxation (Cth) v Murry* (1998) 193 CLR 605; [1998] HCA 42. Before goodwill was eligible for the 50% exemption as an active asset of a small business, 20% exemption was available under *Income Tax Assessment Act 1936* (Cth) Div 19.

[72] *A Tax System Redesigned*, n 3, v. The background of the review is well explained in Taxation Institute of Taxation, “Tax Reform: Let There Be No Half Measures” (1998) 1(4) *Tax Specialist* 185.

[73] The draft legislation, *A New Tax System (Income Tax Assessment) Bill 1999* (Cth), was presented to the House of Representatives in the Parliament of Australia during the 1998–1999 income year.

[74] *A Tax System Redesigned*, n 3, [141]–[142].

[75] See *A Tax System Redesigned*, n 3, [147]–[155].

[76] Some authors argued that the accounting standards of leases are unlikely to be appropriate in taxation: Chris N Westworth, “Accounting Standards – A Framework for Tax Assessment” (1985) 2(3) *Australian Tax Forum* 243; Thomas M Porcano, David M Shull and Alfred V Tran, “Alignment of Taxable Income with Accounting Profit” (1993) 10(4) *Australian Tax Forum* 475, 486. That said, the tax treatment of “finance leases” has often been considered a problem: see, eg, Gordon Mackenzie and Geoffrey Hart, “Finance Lease Taxation: Surviving the TOFA Tsunami” (2008) 23(2) *Australian Tax Forum* 165; John Abrahamson, “Structured Finance: Operating and Finance Leasing in Australia” (2000) 4(2) *Tax Specialist* 82. Some authors argued that special provisions enacted to deny deductions associated with ownership were outdated: John McCormack and David Anderson, “A New Chapter in Restricting Tax Preference Transfers – Section 51AD & Division 16D Reforms” (2003) 6(3) *Tax Specialist* 105. The revision of these rules – Div 250 replacing s 51Ad and Div 16D – shows a shifting trend to use “risk” as a basis for tax treatment, instead of legal ownership: Gordon Mackenzie and Alfred Tran, “Risk as a Measure in Taxing Financial Arrangements” (2011) 26(4) *Australian Tax Forum* 665.

[77] *A Tax System Redesigned*, n 3, [228].

[78] *A Tax System Redesigned*, n 3, [78].

dedicated to recommending amortisation of leases and rights.[79] The review committee defended its selection, asserting that their recommendations were based on individual merit and anticipated benefits ranging from economic growth to promoting equity, simplicity, certainty, or whatever seemed fitting.[80]

Specifically, the report stated that amortisation of leases would remove unfair tax disadvantages arising from deferred deductions and remedy tax avoidance strategies that utilised financing arrangements such as the removal of accelerated depreciation of underlying property coupled with amortisation of leases.[81] In the discussion paper, two approaches were suggested: (1) the *ex-post* "implicit benefits" approach to allow deductions for changes in the value of future benefits and (2) the *ex-ante* "deemed benefits" approach to allow deductions based on systematic depreciation.[82] While the former is based on accrued income, the review committee rejected it in favour of latter. It argued that the latter was more consistent with existing capital allowances available to many tangible assets and such consistency would meet the "investment neutrality principle".[83] This was precarious, however. It was also claimed that the former would not be feasible when income from a particular asset was not separately identifiable,[84] but in practice, returns on investment are generally considered in the context of the present value of investment, rather than whether corresponding income is or is not derived. In operating a business, income is often the result of various types of spending in aggregate, not one isolated expenditure.

Despite anticipated complexity and high compliance costs under either approach,[85] the final report recommended the deemed benefits approach and discussed what design features could be implemented to modify the existing tax system.[86] These were further discussed under the TVM where the design features only confirmed that the recommendations relied on traditional elements. Specifically, immediate deductions were allowed for "routine leases" that had payments commensurate with rent; non-routine leases were subject to depreciation unless they were considered acquisition of underlying property. As shown by tax history, such a tax construct was complex in its attempt to set boundaries at every step of the way. This was not unforeseeable, given that the proposal would reinstate the former lease rules, in addition to capital gains taxation with corresponding difficulties. There were two key problems.

First, routine leases generally referred to leases lasting less than 12 months or lease payments at least as frequent as 12 months.[87] However, the definition of "routine leases" excluded leases involving a high-value property relative to the lease period – specifically, leases with a value greater than $5 million for a lease lasting longer than one year, $1 million for a lease lasting longer than three years, or $0.5 million for a lease lasting longer than five years. Also excluded were leases lasting longer than 90% of the effective life of the property.[88] These exclusions lacked any underlying principle.

Second, the report recommended a depreciation of non-routine leases unless they represented disposal of a leased property. It initially acknowledged the time value of money and mentioned various ways to achieve tax neutrality, such as cost uplift by the CPI for long-term leases and a split tax treatment that treats the premium component as a non-routine lease and the annual rent component as a routine lease.[89] Recommendations followed to provide straight-line depreciation (or the actual rate of usage

---

[79] *A Tax System Redesigned*, n 3, Ch 10.

[80] *A Tax System Redesigned*, n 3, [22]–[50]. The claim that the report achieves these objectives is rhetorical.

[81] *A Tax System Redesigned*, n 3, [262]–[273].

[82] Review of Business Taxation (Chair, John Ralph), Parliament of Australia, *A Platform for Consultation: Building on a Strong Foundation* (Report, February 1999) [10.22]–[10.30] (*A Platform for Consultation*).

[83] *A Tax System Redesigned*, n 3, [277].

[84] *A Platform for Consultation*, n 82, [10.26].

[85] See, eg, Taxation Institute of Australia, "Review of Business Taxation: The Taxation Institute Responds to a Platform for Consultation" (1999) 2(5) *Tax Specialist* 264, 265–66.

[86] *A Tax System Redesigned*, n 3 Ch 10.

[87] See *A Tax System Redesigned*, n 3, Recommendation 10.2.

[88] See *A Tax System Redesigned*, n 3, Recommendations 10.2 and 10.7.

[89] *A Tax System Redesigned*, n 3, 376.

in case of profits *á prendre*) coupled with realisation of capital gains or losses.[90] Accordingly, if there is a renewable lease, the cost paid for a particular period would be deductible evenly over that period, although there might be an expectation that the ownership of underlying property would ultimately be transferred. Because depreciation is based on the period determined at the time of entering or renewing a lease, balancing adjustment would be necessary whenever lease terms were varied to affect the lease period.

As experienced in the past, the distinction between standard leases and leases representing disposal of property (such as perpetual leases) has not been straightforward in defining various terms and conditions of a lease. To some extent, judicial decisions have also reflected the difficulty in determining whether a lease is an acquisition. For example, in one case, a freeholding lease with a fee simple likely to be granted in the future was considered an acquisition of a freehold estate.[91] In another case, the court failed to make a determination about acquisition when a taxpayer split a transaction between two related parties, one of whom was liable to pay an immediately deductible rent and one who held an option to purchase.[92]

Nonetheless, the report similarly attempted to draw a line to define the distinction. Whereas the latter case showed that taxpayers could potentially disguise an acquisition in the form of a lease with an option to purchase, it was suggested that leases with an option to purchase should be treated like a disposal of property, even if the option was not exercised.[93] It was also suggested that easement should be treated like disposal of property.[94] However, none of this considers goodwill, whose value can be shifted to a lease, as was the case under the former lease rules. While the capital allowance was similarly expected to apply to licences, value shifting can occur with any asset that remains subject to capital gains tax. In relation to accelerated depreciation available to tangible assets, tax-induced financial transactions were incentivised, by which lenders could access accelerated depreciation to offset income while borrowers with no income to offset benefited from reduced finance costs in return.[95] To prevent this phenomenon, the report recommended balancing adjustment be exercised upfront, based on whether leases last for a period exceeding more than half of the effective life of the underlying asset.[96] Not only is this test arbitrary, but the suggestion assumes that straight-line depreciation is considered appropriate for leases. On the contrary, accelerated depreciation is often imprecisely calculated as compensation for lost deductions due to the time value of money, so that the total deductions are closer to actual spending in the present value term.

In addition, tax treatment of lessors as espoused in the report indicates further challenges of capital allowances. Deviating from the capital gains tax treatment, the report suggests that ownership rights over land be integrated with related rights that were subsequently granted. For example, if the grant of

[90] *A Tax System Redesigned*, n 3, 375–376.

[91] See *Poole v Commissioner of Taxation (Cth)* (1970) 122 CLR 427. An annual payment of rent towards the purchase price was deductible from the standpoint of a partnership in which Mr Poole was a partner. However, the expense Mr Poole had incurred was considered an outgoing of a capital nature in respect of the Crown land. It would have been assessable income if the land was leased to a third party. Further, the court decided that Mr Poole was unable to establish that his assessment was excessive.

[92] See *Commissioner of Taxation (Cth) v South Australian Battery Makers Pty Ltd* (1978) 140 CLR 645. This case showed the trouble with judicial characterisation that distinguishes revenue and capital expenses: Richard Krever, "Tax Reform in Australia: Base-broadening Down Under" (1986) 34(2) *Canadian Tax Journal* 346, 362. Further doctrinal analysis can be found in Cooper, n 2. After this case was decided, a new anti-avoidance measure was introduced to cancel additional tax benefits and rent expenses in such circumstances in *Income Tax Assessment Act 1936* (Cth) ss 82KH–82KK, as inserted by *Income Tax Assessment Amendment Act 1979* (Cth). These provisions were amended and s 82KL was later added by the *Income Tax Assessment Amendment Act (No 4) 1979* (Cth).

[93] *A Tax System Redesigned*, n 3, 375.

[94] *A Tax System Redesigned*, n 3, 375.

[95] See, eg, Razeen Sappideen, "Tax Aspects of Financing Transactions" (1990) 6 *Queensland University of Technology Law Journal* 1; Graeme S Cooper, "The Treatment of Expenditure on Environmental Protection under the Income Tax: A Note on the Operational Distortions of Nothings" (1991) 8(2) *Australian Tax Forum* 135; Michael Bearman and Arnold Bloch Leibler, "Strict Limits on Australian Options" (1994) 5 *International Tax Review* 24; Julie Cassidy, "Devil's in the Detail: Non-commercial Business Losses" (2008) 3(2) *Journal of the Australasian Tax Teachers Association* 87.

[96] See *A Tax System Redesigned*, n 3, Recommendation 10.8.

rights to remove gravel or trees from land reduces the value of land by 10%, the cost base of the land acquired for $100,000 will be reduced by 10%, while the equivalent value at the time of the grant (say, $8,000) reduces the gross receipt assessed as a capital gain.[97] The report also suggests that the grant of a lease of over 10 years be coupled with taxation of an unrealised capital gain. For example, if a 20-year lease represents reduction in the present value of underlying land and buildings by 60%, 60% of the premium received for granting the lease is compared with 60% of the historic value of underlying assets to recognise any capital gain or loss at the time of the grant.[98] These criteria potentially propose complex cost adjustment rules for leases in situations where lessees, instead of property owners, assign or transfer any part of the rights granted under the lease temporarily or for the remaining period of the lease.

After the release of the Review, the government initially supported the adoption of new lease rules to fix the asymmetry with respect to time for recognising income and allowing deductions.[99] A working group chaired by Dick Warburton was set up to consult on the development of the recommendations. The working group endorsed the government’s plan to implement a new regime for leases, although the wholesale redraft of the tax law to adopt the TVM was not supported due to uncertainty about the effects of its applications.[100] The government did not pursue the TVM but, for a while, considered the implementation of new rules for leases and rights.

However, the details of how a depreciation regime might operate, as suggested in the RBT, reveal a lack of consideration given to the problems and difficulties encountered in the historic lease rules discussed in Part II. The division between immediate deductions and depreciation deductions is too arbitrary and absent of any proper underlying principle, and the recommendation in the report also fails to remedy the bias against long-held assets.

Finally, the government announced in the 2005/2006 Budget that the new rules would not be implemented since they would make the tax laws more complex, hence exacerbating integrity issues.[101] Since then, no attention has been given to the tax treatment of leases at the governmental level.

V. UK Proposal towards A Neutral Tax Base

Drafting tax rules for leases, it appears, has been difficult due to dogmatic approaches towards characterising expenses and categorising assets. On its face, capital allowances are preferred to the current capital gains tax treatment but also likely to add unprecedented complexity. Where the intangible nature of assets that cannot be seen or touched intensifies the integrity risks associated with relabelling for preferable tax outcomes, this part of the paper shows that there is a better option. This option, suggested by Adam and Miller in their seminal work published in January 2021, hereafter called the “IFS Report”,[102] measures a neutral tax base more accurately than the measurement based on tax deprecation or the capital gains tax regime.

The IFS Report provides several models to find the same tax base irrespective of when costs are recognised – that is, taxes are imposed on the same value, irrespective of taxing time. It deviates from the tradition that deductions are allowable for economic losses as represented by the diminished value of an asset. Further, in applying the models, any losses are treated in a way that is symmetrical with

[97] See *A Tax System Redesigned*, n 3, Examples 10.1 and 10.7.

[98] See *A Tax System Redesigned*, n 3, Recommendation 10.5.

[99] Treasurer Peter Costello, “The New Business Tax System” (Press Release, No 74, 11 November 1999); Treasurer Peter Costello, “Tax Value Method” (Press Release, No 81, 7 August 2000). The government noted tax minimisation strategy involving assignments earlier that year: Glen Barton, “The Ralph Report: Reforming the Capital Allowances System” (1999) 34(5) *Tax Specialist* 249, 250. For more information, refer to the government response in Michael Dirkis and Antony Ting, “Cataloguing Business Tax Reform Seven Years On” (2006) 21 *Australian Tax Forum* 601, 626.

[100] Board of Taxation, Commonwealth of Australia, *Evaluation of the Tax Value Method: A Report to the Treasurer and Minister for Revenue and Assistant Treasurer* (July 2002) [113].

[101] Australian Government, *Budget Measures 2005–2006* (Budget Paper No 2, May 2005) 25.

[102] *Taxing Work and Investment across Legal Forms*, n 4.

gains. Thus, no bias will result from the type of asset or investment. There are no distortions to retention decisions and no concerns about lock-in effects.

Before discussing the models further, it is necessary to explain the concept of the time value of money and how this affects a neutral tax base. The concept holds that $1,000 spent today is less than $1,000 to be spent tomorrow. To account for the time value of money in this scenario, let us use a normal or risk-free rate of return on investment.[103] If a normal rate of return is denoted at 5% per annum, a deduction of $1,000 next year is equivalent to $952.38 in the present value terms, when compounded annually.[104] Applying the same mechanism, the total deduction of $1,000 equates to $909.19,[105] if deducted on straight line over five years; or $822.70,[106] if deducted in the fifth year. Alternatively, $1,000 spent today requires evenly spread five-year deductions totalling $1,100 or a deduction of $1,216.51 in the fifth year. See Table 1.

TABLE 1. Worked Example: Differed Timing of Deductions

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Cash outgoing	$1,000					
Case 1: cash-based deduction						
Upfront deduction	1,000					1,000
					Total:	1,000
Case 2: capital allowance						
Capital allowance	200	200	200	200	200	1,000
Reduced cost base	800	600	400	200	0	
Adj. annual return rate of five%*		40	30	20	10	100
					Total:	1,100
Case 3: deferred deduction						
Deferred deduction					1,000	1,000
Adj. annual return rate of 5%**					216.51	216.51
					Total:	1,216.51

* Calculated as the reduced cost base in the preceding year, multiplied by the annual return rate of 5%.

** Calculated as the rate of return compounded to $1,000 annually (ie, $\$1,000*1.05^4–1,000$).

To avoid the tax base distortions caused by the timing of deductions, the IFS Report initially mentions an option of taxing no capital income but rejects this because of the potential risk that labour income may be disguised as capital income to avoid taxes.[107] There is no established way of distinguishing labour income from capital income – for example, business income is derived partly from labour and partly from capital. Subsequently, two other models are suggested as equally sound in theory.[108] These

[103] *Taxing Work and Investment across Legal Forms*, n 4, 102–103. The concept of the "normal" rate of return has been discussed in vast literature: see, eg, Stuart Adam et al, "Dimensions of Tax Design" (Institute for Fiscal Studies, September 2010) Ch 6; *Tax by Design*, n 5, Ch 13; Spencer Bastani and Daniel Waldenstrom, "How Should Capital Be Taxed?" (2020) 34(4) *Journal of Economic Surveys* 812.

[104] The present value can be calculated as future value divided by $(1+r)^n$, where by r is the rate of return and n is the number of periods. Thus, $\$1,000/1.05^1 = \$952.38$ (rounded to the two decimals).

[105] $\$909.19 = (1,000/5) + (1,000/5)/1.05^1 + (1,000/5)/1.05^2 + (1,000/5)/1.05^3 + (1,000/5)/1.05^4$.

[106] $\$822.70 = 1,000/1.05^4$.

[107] *Taxing Work and Investment across Legal Forms*, n 4, 69.

[108] *Taxing Work and Investment across Legal Forms*, n 4, 78–108.

models are considered for the treatment of lease payments with consideration of potential responses to the changes in practice.

The first is the "cash flow" method that allows deductions upfront. The tax base calculated under this method is the benchmark for a neutral tax base and this is the simplest approach in practice. However, the authors of the IFS Report warned that the government may hesitate to adopt it if there is an immediate budget need or because of anticipated fall in revenue during the transitional period. Alternatively, the second method provides modifications to capital allowances and capital gains tax treatment, which adjust deductions as necessary by the time value of money. The adjustment amounts are additionally deductible to compensate for the deferral of deductions (or to allow full deductions in the present value term), which can be called "deferred allowances". This type of deduction, in theory, removes any incentive or disincentive to change the timing of deductions because, whenever taxed, taxable amounts are of the same value. While characterisation exists to distinguish revenue or capital expense and wasting and non-wasting asset, this is not significant. In practice, the second method is less simple but likely to be more appealing since it requires smaller changes to the current system. From the perspective of taxpayers, this is more favourable than the existing system of deductions.

However, tax neutrality under the deferred allowance method depends on soundness of a normal rate of return used for tax purposes. Whereas ideally, a normal rate of return should vary to maintain tax neutrality of assets across time, this introduces different rates and frequencies of compounding for different assets, which can be mind-bogglingly complex. Instead, of attempting to achieve absolute tax neutrality, the IFS Report, to attain simplicity, suggests a normal rate of return indexed by the normal interest rate on medium-term government bonds.[109] In Australia, the all groups CPI weighted average of eight capital cities has been used to uplift the costs of CGT assets, which shows that the annual release of cost uplift factors is not too unfamiliar to be implemented. Whichever is determined to be most appropriate and subsequently chosen can be applied to calculate deferred allowances annually. This calculation can be done for every asset or based on a portfolio (a group of similar assets), a business line, or a taxpayer.

Table 1 showed how deferred deductions are adjusted to achieve the total deduction for $1,000 cash paid in the first year. The time value adjustments in that table are essentially commensurate with deferred allowances adjusted for the normal rate of return, in this case assuming 5% annually compounded. Table 2 further demonstrates how to deal with unused deferred allowances in a simple scenario where $1,000 paid in the first year is deductible in the fifth year with the taxpayer deriving no income until that year.

TABLE 2. Unused Deferred Allowances

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Deductions**
Cash outgoing for asset	$1,000					1,000
Normal rate of return at 5% p.a.	0	50	52.5	55.13	58.88	216.51
					Total:	1,216.51
Case 1: Adding to asset's cost base						
Asset cost reduction					1,000	1,000
Asset cost uplifts, accumulate			50	102.50	157.63	157.63
(New) deferred allowance		50	52.5	55.13	58.88	58.88
					Total:	1,216.51

[109] *Taxing Work and Investment across Legal Forms*, n 4, 103.

TABLE 2. continued

Case 2: Carrying forward in deferred allowance account						
Asset cost reduction					1,000	1,000
Deferred allowance, accumulated		50	102.5	157.63	216.51	216.51
					Total:	1,216.51

In Case 1, deferred allowances start accruing from the second year. The unused deferred allowance of $50 in the second year is added to the cost base of an asset in the third year. In the third year, a new deferred allowance is calculated based on the (non-deducted) cost of an asset with regard to the amounts that had not been yet deducted. In this case, because no deduction has been applied, $1,000 in the first year is equivalent to $1,102.5 (ie, $1,000*1.05^2). This amount is reduced by the asset cost of $1,000 and the deferred allowance of $50 added to the cost base in the previous year, which is a newly calculated deferred allowance amounting to $52.5 (ie, $1,102.5 – 1,000 – 50). If this is unused in the third year, it is added to the cost base of an asset in the fourth year, with the process continuing. New deferred allowances are always calculated based on the cost base of an asset without augmentation by any unused deferred allowance amounts. Instead of adding unused deferred allowances to the cost base of an asset, in Case 2, unused deferred allowances are carried forward in the same deferred allowance account. The only difference is that, because the deferred allowance account is ready for deductions, unused allowances accumulated in the previous years need not await deductions until when an asset can be written off. While this method is simpler than the approach taken in Case 1, either method or both methods may be chosen as appropriate in a given tax environment. The same mechanics can be applied to capital allowances. In that case, the order of deductions between the cost of an asset and deferred allowances needs to be considered because deferred allowances are calculated based on the written-down cost of an asset.

Notably, capital allowances may be preferable since they allow earlier deductions, although the total amount of deductions is ultimately the same in the money value term. However, this is not always true, so removal of capital allowances can be justified. While no capital allowances mean smaller deductions in earlier years, this is compensated by the normal rate of return applicable to the retained (not the written-down) cost of an asset. If an asset is never sold, but fully used or scrapped, deferred allowances continue accumulating.[110] This raises a query about the effect on marginal tax rates, because capital allowances may push the applicable tax rate into a low rate bracket. However, it is debatable whether this effect called "smoothing" or "averaging income", is good or bad.[111] Overall, it is not as significant as the problem arising from failing to tax on a neutral tax base.

One last point in this discussion concerns alternative ways suggested for taxing companies to remove debt and equity bias. The IFS Report suggests a *real* cash flow approach (R base) that ignores interest income and interest expenses but concludes that this is inappropriate because an excess return yielded from financial transactions is an unjustifiable windfall.[112] The second *real and financial* cash flow base (R+F base) is same as the cash flow method akin to expenditure taxation discussed earlier, including financial transactions. The R+F base can be alternatively calculated as (re)purchase of shares (and dividend payments) *minus* shares issued or sold (and dividends received).[113] This approach is called the S base and can be modified to work out deferred allowances by multiplying the end-of-year equity stock–that is, opening equity stock *plus* net equity issued/sold *plus* retained taxable profits–by the normal rate of return.[114] The S base (or the S base modified for deferred allowances) is alien to Australian taxation and may require considerable time and effort to attract support.

[110] *Taxing Work and Investment across Legal Forms*, n 4, 95.

[111] *Taxing Work and Investment across Legal Forms*, n 4, 138–139.

[112] *Taxing Work and Investment across Legal Forms*, n 4, 88.

[113] For detailed illustration of possible corporate tax bases, see *Taxing Work and Investment across Legal Forms*, n 4, 87–89.

[114] *Taxing Work and Investment across Legal Forms*, n 4, 99–102.

VI. Summary of Findings and Recommendations

Currently, the Australian income tax system recognises lease premiums and lease-related costs as capital losses. Special provisions exist to distinguish leases from rights over land and in relation to reversionary interests, consideration received for agreeing to vary or waive lease terms and long-term leases (compare mining leases excluded for policy reasons to support the industry). However, tax treatment of some other costs, such as lease incentives and consideration received for the surrender of a lease, remains ambiguous.

This article finds that the timing of deductions under the current capital gains tax regime challenges the important tax policy principle of tax neutrality that attempts to reduce behavioural distortions in taxpayers' economic decision-making in the 21st century market economy. The RBT suggested introducing a depreciation regime to treat multiyear leases equivalent to plant and equipment, unblocking the restrictions imposed on the tangible-intangible character dichotomy. Accordingly, the former capital rules, which existed from the inception of the federal income tax in 1915 until 1964, were examined along with the design features of lease rules suggested by the RBT.

Although capital allowances are comparatively preferable to capital gains tax treatment from the perspective of tax neutrality, they require characterisation of leases and this in turn can give rise to a different suit of complexities – for example, whether a cost should be considered a rent substitute or commuted rent, which is immediately deductible; whether capital gains tax treatment is more appropriate because a lease is akin to a conveyance (eg, perpetual lease and a Crown lease used for primary production) or goodwill or the licence for a business carried on leased premises. This boundary issue is almost always arbitrary because terms of a lease can be drafted in many ways, while significantly different tax treatments cannot be justified from an economic perspective. The RBT suggested legislative guidance to draw a line between routine leases and non-routine leases and between genuine non-routine leases and non-routine leases representing transfers of underlying property. However, this is likely to add further complexities and distortions suffered by characterisation. For example, excluding high-value leases relevant to lease periods for routine leases has no clear basis; having an option to purchase can result in the characterisation of a perpetual lease.

Subsequently, the IFS Report was sought to understand what tax neutrality entails. It finds that the current system of both capital allowances and capital gains tax augments true profits for taxing and, for measuring a neutral tax base, deferred allowances should be added to any deferred deduction to allow full deductions in the present value term. In other words, to pursue the tax neutrality goal, it is necessary to modify the current capital gains tax treatment relating to leases although complete removal of an investment bias to treat similar economic consequences in a like manner can only be achieved when all existing capital allowances and capital gains tax rules are amended to incorporate deferred allowances.

Broadly, this article suggests three methods be adopted for deducting costs related to the right to use property under a leasing or subleasing arrangement in the Australian income tax system. The first is to allow immediate deductions for all cash outgoings, which is called the cash-based method. This is a preferred method for practical simplicity and theoretical soundness because, unlike this method, other methods require benchmarking a risk-free rate of return to incorporate deferred allowances. If, however, implementing this method is politically difficult, deferred allowances can be built into either the capital gains tax regime or, if leases are recognised as wasting assets, capital allowances.

The second preferred method is to modify the capital gains tax regime with differed allowances. Benefits of this approach include: first, leases are currently treated as CGT assets; second, it removes any cost uplift mechanism that currently applies on an inconsistent and distortionary basis (ie, indexation and partial capital gains exemption for individuals, etc[115]). Any unused deferred allowances can be carried forward in the deferred allowance account, rather than adding them to the cost base of a lease, for administrative simplicity. Crucially, capital losses must be allowed full utilisation in a timely fashion. The loss quarantine rule distorts investment decisions, while it is simply irrational when applied to intangible assets that decline in value over time, like leases. At this juncture, assuming that capital

[115] *Income Tax Assessment Act 1997* (Cth) Divs 114–115.

allowances do not have requisite deferred allowances, taxpayers are unlikely to attempt to relabel leases as depreciable assets because depreciable assets are ineligible for full deductions in the money value term, although capital allowances allow more deductions in earlier years.

The last possibility is to introduce a capital allowance regime for leases, with the deferred allowance calculation. There are two ways to go about modifying the existing capital allowances. The first is to incorporate deferred allowances in the capital allowance regime in a manner similar to that in the preceding paragraph, with the difference being the cost base spread out across the effective life of a lease (eg, straight-line depreciation). The second is to extend the asset write-off rules to a broad category of depreciable assets. Immediate asset write-off rules have been popular among small businesses in recent years, and these rules were greatly extended in the face of the coronavirus pandemic in 2020.[116] While some assets continue to be subject to immediate write-off, it is desirable that other assets that are depreciable over time be accompanied by a deferred allowance calculation to achieve full deductions.

Introducing, for leases, a capital allowance regime with deferred allowances does not eliminate three deduction categories: immediate deductions, capital allowances and capital gains tax treatment. However, by adjusting deductions according to its timing with deferred allowances, there is no change in overall tax liability. Attempting to deduct lease payments earlier (or later) is unnecessary because deferred allowances make the overall deductions as valuable as upfront deductions.

Overall, the three high-level methods were suggested above on the bases that tax neutrality should be the underlying tax policy principle on the treatment of leases, particularly the costs incurred in obtaining the right to use property under a lease or sublease arrangement. Further study can be carried out to formulate the details of the suggested models. For example, implementing deferred allowances requires appropriate setting of the normal rate of return and determination of whether deferred allowances would be calculated on the basis of an asset, a portfolio, a business or a taxpayer. It may be necessary to consider potential tax avoidance strategies that may arise under the deferred allowance system and further developments about the benchmarking of corporate tax integration.

[116] *Income Tax Assessment Act 1997* (Cth) ss 40-82, 328-180; *Income Tax (Transitional Provisions) Act 1997* (Cth) s 328-180, Div 40-BA.