THE TAXATION FROM LEASING

RELEVANT TO PAPER P6 (MYS)

THE INCOME TAX FOR COMPANIES CARRYING ON LEASING ACTIVITIES FALLS WITHIN PART A1(b) (III) OF THE *STUDY GUIDE* FOR PAPER P6 (MYS).

The income tax for companies carrying on leasing activities falls within Part A1(b) (iii) of the *Study Guide* for Paper P6 (MYS).

A lease is an arrangement whereby one party, the lessor, transfers an asset and the rights to use the asset to another party, the lessee, in return for lease rentals over a period of time, the lease term. Leasing arrangements cover many types of property such as motor vehicles, office equipment, aeroplanes, buildings and toll roads. However, this article focuses on the tax treatment of the lessor on a lease of moveable property.

CLASSIFICATION OF LEASE AGREEMENTS

Operating lease

An operating lease agreement is similar to a typical rental agreement on a real property where the lessee has the right to use the asset in return for monthly lease payments over the lease term. Nevertheless, the legal ownership of the leased asset remains with the lessor. Since the lessor is the owner of the leased asset, the lessor is entitled to claim capital allowances on the asset. The lessor is also responsible for maintenance and insurance of the asset and those expenses are generally tax deductible. Lease rentals, which include both the capital and interest portions, are recorded as the lessor's gross income.

Finance lease

Under an operating lease, it is never intended that the legal ownership of the asset will pass to the lessee. However, other forms of lease, often referred to as finance leases, have developed over time. A finance lease is basically an agreement that allows the legal ownership of the leased asset to be transferred from the lessor to the lessee on full payment of all of the lease payments. Usually, the effective ownership of the leased asset is given to the lessee in anticipation of the transfer of the legal ownership. Hire purchase is one example of a finance lease with which you are probably familiar. The question of who should be treated as the owner during the period in which hire purchase payments are being made is resolved by law (Paragraph 46, Schedule 3, Income Tax Act 1967 (ITA)). Under a hire purchase agreement, the aquirer is allowed to claim capital allowances each year of assessment to the extent that he has made payments under the agreement. There are other types of finance lease which are not hire purchase but cannot be regarded as operating leases either. Until the introduction of the Income Tax Leasing Regulations 1986 (ITLR), there was considerable doubt as to how such leases should be treated.

Income Tax Leasing Regulations 1986

Section 36 of the ITA provides that the Director General of Inland Revenue can issue regulations specifying the treatment for a hire purchase transaction, a transaction in which a debt is paid by instalments and a lease transaction for a moveable property. The issuance of the ITLR was made under this section.

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OF INCOME TRANSACTIONS

The ITLR is an anti-avoidance measure intended, among other things, to deny the benefit of capital allowances to a lessor under a finance lease. It applies to the lessor but not to the lessee. There are three main principles that a candidate must appreciate in applying the ITLR to any lease:

1 Lease rentals accrue evenly

Under the ITLR, the total lease rentals of a lease term receivable in respect of a lease shall be deemed to accrue evenly, unless the Director General of Inland Revenue (DGIR) considers that it is just and reasonable in the circumstances, to allow the actual terms of the lease to prevail throughout the lease term. The gross income of the lessor in respect of that lease for a basis period for a year of assessment shall be a fraction of the total sum receivable. The fraction is the number of days in that basis period that fall within the lease term over the total number of days inbetween. However, for exam purposes, the apportionment is based on the number of months in the lease term.

Example 1 (based on Question 1 from Paper 11 of December 1997 exam)

Asset A is leased over 36 months commencing from 1 January 2008. The rentals are RM3,000 per month for the first 24 months and RM3,300 per month for the final 12 months. The lessor's basis period ends on 30 June 2009.

A LEASE IS AN ARRANGEMENT WHEREBY ONE PARTY, THE LESSOR, TRANSFER THE ASSET AND THE RIGHTS TO USE THE ASSET TO ANOTHER PARTY, THE LESSEE, IN RETURN FOR LEASE RENTALS OVER A PERIOD OF TIME, THE LEASE TERM.

Tax treatment: Under ITLR, the lease rentals on asset A are deemed to accrue evenly throughout the lease term. Therefore, the deemed lease rental for year of assessment 2009 is RM37,200 (RM3,100* x 12 months), unless the DGIR allows the lease agreement to apply without revision, in which case the lease rentals will be RM36,000 (RM3,000 x 12 months).

* Deemed lease rentals per month =

$$\frac{(\text{RM}3{,}000 \times 24 \text{ months}) + (\text{RM}3{,}300 \times 12 \text{ months})}{36 \text{ months}}$$

= RM3,100

2 Deemed to be a sale agreement

The ITLR provides that a lease agreement shall be deemed to be a sale agreement if any one of the following conditions is satisfied:

(i) the lessee is given an option to purchase the asset during the lease term or upon expiry
(ii) the lessee is given the beneficial ownership of the asset
(iii) the lessee during the lease term or upon expiry of the lease term acquires directly or indirectly the asset otherwise than at its market value at the date of such acquisition
(iv) the asset is a special purpose asset; "special purpose asset" means a leased asset where no other user can use the same asset without making alterations or dismantling from a structure or land; and such special purpose asset shall be deemed to be a movable property for the purpose of Section 36(1) of the Income Tax Act, 1967
(v) the lessee has claimed capital allowances in respect of the asset prior to the lease or
(vi) the lessee is given the right to sell or dispose of the asset and receives the proceeds or a portion of the proceeds from the sale.

When an agreement is treated as a sale agreement for income tax purposes, the implication is that the agreement is treated as a non-leasing agreement. This is important because it means that the transaction will not be treated as part of the (deemed) separate leasing business of the lessor (see below). Candidates should note that substantial marks are allocated for stating whether or not a particular lease agreement is a deemed sale agreement and explaining the reasons why. The deemed sale agreement should not be seen as a normal sale of goods where the seller makes a trading profit. In this case, his profit is derived from financing the transaction and candidates should treat it as accruing over the period of the lease.

Example 2 (based on Question 1 from Paper 11 of December 1997 and on Question 1 from Paper 3.2 of December 2001 exams)

A lease of asset B was granted on 1 July 2008 for 72 months with rentals of RM900 per month. The leased asset was installed in the lessee's premise and cannot be used by any other person without altering or dismantling it. The lease rentals for the basis period for year of assessment 2009 total RM10,800 (RM900 x 12 months) of which RM8,340 relates to the interest portion.

Tax treatment: Under the ITLR, the lease of asset B is a deemed sale agreement because asset B is a special purpose asset. The asset is a special purpose asset because no other user can use the same asset without making alterations or dismantling from the lessee's premises. Therefore, the gross income is RM8,340, the interest accrued in the basis period.

A lease of asset C was granted on 1 July 2008 for 72 months with rentals of RM10,000 per month. The asset cost RM468,000. The lessee may purchase it for RM10 at the end of the lease term. The lease rentals for the basis period for year of assessment 2009 total to RM120,000 (RM10,000 x 12 months) of which RM21,000 relates to the interest portion.

WHEN AN AGREEMENT IS TREATED AS A SALE AGREEMENT FOR INCOME TAX PURPOSES, THE IMPLICATION IS THAT THE AGREEMENT IS TREATED AS A NON-LEASING AGREEMENT. THIS IS IMPORTANT BECAUSE IT MEANS THAT THE TRANSACTION WILL NOT BE TREATED AS PART OF THE (DEEMED) SEPARATE LEASING BUSINESS OF THE LESSOR.

Tax treatment: Under the ITLR, the lease of asset C is a deemed sale agreement because the lessee is given an option to purchase the asset at the end of the lease term. Therefore, the gross income is RM21,000, the interest accrued in the basis period.

A lease of asset D was granted on 1 April 2009 for 60 months with rentals of RM20,000 per month. The asset was purchased for RM810,000 from the lessee, who had owned it for three years and claimed capital allowances on it. He has no right to reacquire it, but is permitted to continue to lease it for a nominal sum at the expiry of the lease term. The lease rentals for the basis period for year of assessment 2009 total to RM60,000 (RM20,000 x 3 months) of which RM19,500 relates to the interest portion.

Tax treatment: Under the ITLR, the lease of asset D is a deemed sale agreement because the lessee claimed capital allowances on the asset prior to the lease term. Therefore, the gross income is RM19,500, the interest accrued in the basis period.

A lease of asset E was granted on 1 January 2009 for 60 months, with rentals of RM15,000 per month throughout the lease term. The asset was purchased from the lessee for RM600,000. The lessee, who owned the asset for two years but was not eligible to claim capital allowances, has no right to reacquire it. The lease rentals for the basis period for year of assessment 2009 total to RM90,000 (RM15,000 x 6 months) of which RM30,000 relates to the interest portion.

Tax treatment: Under the ITLR, the lease of asset E is not a deemed sale agreement since the lessee did not claim capital allowance prior the lease term. The fact that the lessee owned the asset for two years is not relevant. Therefore, the gross income is the lease rentals of RM90,000 accrued in the basis period and the lessor is entitled to claim capital allowances on the leased asset.

A lease of asset F was granted on 1 December 2008 for 60 months with rentals of RM3,000 per month throughout the lease term. The asset cost RM120,000. The lessee has no right to acquire it. The lease rentals for the basis period for year of assessment 2009 are RM21,000 (RM3,000 x 7 months) of which RM7,000 relates to the interest portion.

Tax treatment: Under the ITLR, the lease of asset E is not a deemed sale agreement. Therefore, the gross income is RM1,000, the lease rentals accrued in the basis period and the lessor is entitled to claim capital allowances on the leased asset.

A lease of asset G (general machinery) was granted on 1 May 2006 for 36 months with rentals of RM25,000 per month. The asset cost RM600,000. The lease rentals for basis period for the year of assessment 2009 are RM250,000 (RM25,000 x 10 months) of which RM60,000 relates to the interest portion. Although the lessee had no legal right to acquire the asset, it was sold to the lessee for RM10 when the lease term ended on 30 April 2009.

Tax treatment: Under the ITLR, the lease is deemed to be a sale agreement because the lessee acquired the asset during or on expiry of the lease term at a price other than market value, In practice, market value is taken to be equal to 80% of the tax written-down value of the asset, which would certainly exceed the RM10 sale price of asset G. Therefore, the gross income for the year of assessment 2009 is RM60,000, the interest accrued in the basis period plus the sale proceed of RM10. As previous years' computations will have been made on the basis that the agreement is a lease and not a sale, retrospective adjustments would have to be made.

IN ASCERTAINING THE GROSS INCOME OF A LESSOR WHICH CONSISTS OF LEASING TRANSACTIONS AND OTHER ACTIVITIES, THE GROSS INCOME FROM THE LEASE TRANSACTIONS ARE DEEMED TO BE A SEPARATE AND DISTINCT BUSINESS SOURCE FROM OTHER ACTIVITIES OF THE LESSOR.

3 Separate and distinct business source

In ascertaining the gross income of a lessor which consists of leasing transactions and other activities, the gross income from the lease transactions are deemed to be a separate and distinct business source from other activities of the lessor.

The ruling prescribes that leasing and non-leasing transactions are treated as two business sources. Consequently, two separate computations are necessary, separating the respective gross incomes, lease rentals for the leasing business and finance income for the non-leasing business. Specifically identifiable expenses and capital allowances, such as capital allowances on leased assets, will be deductible directly at the correct stage in computing the statutory income from each source. However, the artificial splitting of a company's activities means that many deductions need to be apportioned.

The question of how such apportionments should be made has been the subject of considerable controversy. So far as common expenses are concerned, this was resolved by the decision of the Court of Appeal in Daya Leasing S/B handed down in 2005, whereby it was held that common expenses should be apportioned on the basis on gross taxable income, ie for leasing transactions - lease rentals (capital + interest) and for non-leasing - interest only (KPHDN v Daya Leasing Sdn Bhd [2005] MSTC 4,124; [2003–2005] AMTC 130). It is accepted that this basis should also apply to common capital allowances (that is in respect of non-leased assets in use for the business generally). Nevertheless, this failed to resolve the controversy over the method of apportioning interest expense. In spite of a Budget proposal in 2006 to prescribe a basis for apportioning interest expense between leasing and non-leasing businesses based on amount of funding used, no new law has been gazetted. Therefore, candidates are advised to ignore the Budget proposal and follow the basis prescribed in the Daya Leasing case for interest as well as other expenses for the time being.

In order to make the apportionments required, candidates will need to determine the gross income from each source, even if they are required to start the computation of adjusted income with the profit before tax figure.

Example 3 (based on Question 1 from Paper 11 of December 1997 and Question 1 from Paper 3.2 of December 2001 exams)
See **Table 1** on **page 7**.

Definitions
- ‘lease’ means any kind of agreement or arrangement under which payments are made for the use of an asset
- ‘lease term’ means:
  - (i) the period for which the lessee has contracted to lease an asset or
  - (ii) where a lease arrangement has been terminated earlier than its expiry the actual period of the lease (provided that where the lessee exercises an option to continue to lease the asset such further term shall constitute a new lease term).

Tax computation
A candidate must be very careful when reading the requirement in any exam question. It may ask for the computation to begin from the gross income or from the profit before tax. Failure to follow the instruction given in the requirement would not earn full marks.

Example 4 (based on Question 1 from Paper 3.2 of the December 2001 exam)
Goodboy Finance Sdn Bhd (‘Goodboy’) carries on a hire-purchase and leasing businesses. Accounts are made up to 30 June each year and the accounts to 30 June 2009 showed the following results:

	RM	RM
Revenue		1,689,480
Less: expenses		
Staff, office and administrative expenses	460,000	
Directors’ remuneration	240,000	
Depreciation	290,000	
Interest on borrowing	280,000	
		(1,270,000)
Profit before tax		419,480

Notes:
(1) Revenue comprises:

		RM
Income earned from operating leases	Note 2	742,490
Income earned from hire purchase agreements		709,480
Income earned from other finance leases	Note 3	237,510
		1,689,480

(2) Income earned from operating leases comprises lease rentals of:

	RM
Asset A	36,000
Asset B	10,800
Other operating leases	695,690
	742,490

(3) Income earned from other finance leases comprises ‘interest’ on the transactions. It is made up of:

	RM
Asset C	21,000
Asset D	19,500
Asset E	30,000
Asset F	7,000
Asset G	60,010
Other finance leases	100,000
	237,510

A CANDIDATE MUST BE VERY CAREFUL WHEN READING THE REQUIREMENT IN ANY EXAM QUESTION. IT MAY ASK FOR THE COMPUTATION TO BEGIN FROM THE GROSS INCOME OR FROM THE PROFIT BEFORE TAX. FAILURE TO FOLLOW THE INSTRUCTION GIVEN IN THE REQUIREMENT WOULD NOT EARN FULL MARKS.

(4) For the year of assessment 2009, capital allowances for common assets are RM85,000 and for leased assets RM655,762. Unabsorbed capital allowances for leased assets brought forward are RM600,000 (see **Table 2** on **page 8**).

Required:
Starting from gross income, determine the adjusted income and statutory income of Goodboy for each of its business sources for year ended 30 June 2009.

Example 5
Similar to **Example 4**, except now a candidate is required to prepare the tax computation starting from the profit before tax (see **Table 3** on **page 9**).

Note that the tax computation for the non-leasing business is the same whether the computation begins from the profit before tax or from the gross income. Only the adjustments for the leasing business differ when the tax computation begins from the profit before tax instead of the gross income. The computation of a leasing business is similar to any computation for a taxpayer with business income. In addition, there are some adjustments which are specific to a leasing business. Since the profit before tax includes both the income of leasing and non-leasing businesses, when an agreement is treated as a non-leasing agreement, the amount previously recognised in the accounts needs to be reversed out. When an agreement is treated as a leasing agreement (as in asset A, E and F), an adjustment is made to take into account the difference between the income for tax purposes and the amount recognised as income for accounting purposes.

THE TAX COMPUTATION FOR THE NON-LEASING BUSINESS IS THE SAME WHETHER THE COMPUTATION BEGINS FROM THE PROFIT BEFORE TAX OR FROM THE GROSS INCOME. ONLY THE ADJUSTMENTS FOR THE LEASING BUSINESS DIFFER WHEN THE TAX COMPUTATION BEGINS FROM THE PROFIT BEFORE TAX INSTEAD OF THE GROSS INCOME.

Tax treatment of the lessee
The tax position of the lessee is not affected by whether the lease is a deemed sale agreement or not as the ITLR only applies to the lessor. For a leasing agreement, the lease rentals incurred by lessee are deductible in arriving at adjusted income for any year of assessment, subject to any other restriction imposed by law. For a hire purchase agreement, the acquirer claims capital allowances on the asset (provided the asset is a qualifying asset) for each year of assessment. The qualifying expenditure on the asset is the capital portion of instalments paid, subject to any other restriction imposed by law.

REFERENCES
- Income Tax Leasing Regulations 1986
- Ketua Pengarah Hasil Dalam Negeri v Daya Leasing Sdn Bhd [2005] MSTC 4,124; [2003-2005] AMTC 130

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TABLE 1: EXAMPLE 3 (BASED ON QUESTION 1 FROM PAPER 11 OF DECEMBER 1997 AND QUESTION 1 FROM PAPER 3.2 OF DECEMBER 2001 EXAMS)

Gross income	**Leasing**	**Non-leasing**	
Leases	**RM**	**RM**	
A	37,200		
B		8,340	
Other operating leases	695,690		
C		21,000	
D		19,500	
E	90,000		
F	21,000		
G		60,010	
Hire purchase		709,480	
Other finance leases		100,000	
Gross taxable income	843,890	918,330	Total = 1,762,220
Apportionment	47.89%	52.11%	

'LEASE' MEANS ANY KIND OF AGREEMENT OR ARRANGEMENT UNDER WHICH PAYMENTS ARE MADE FOR THE USE OF AN ASSET. 'LEASE TERM' MEANS THE PERIOD FOR WHICH THE LESSEE HAS CONTRACTED TO LEASE AN ASSET OR WHERE A LEASE ARRANGEMENT HAS BEEN TERMINATED EARLIER THAN ITS EXPIRY, THE ACTUAL PERIOD OF THE LEASE

TABLE 2: EXAMPLE 4 (BASED ON QUESTION 1 FROM PAPER 3.2 OF THE DECEMBER 2001 EXAM)

Goodboy Finance Sdn Bhd **Year of assessment (YA) 2009**			**Leasing business**	**Non-leasing business**
		RM	**RM**	**RM**
Gross income (see **Example 3**)			843,890	918,330
Less: Common deductible expenses				
Staff, office and administrative expenses		460,000		
Directors' remuneration		240,000		
Interest on borrowing		280,000		
	(W1)	980,000	(469,322)	(510,678)
Adjusted income			374,568	407,652
Less: Capital allowances				
Common capital allowances*			(40,707)	(44,293)
Capital allowances on leased assets*	(W2)		(333,861)	0
Statutory income			0	363,359

* Separated for illustration purposes.

	Leasing business	**Non-leasing business**
Working 1 (W1)	**RM**	**RM**
Apportioned common deductible expenses		
RM980,000 x 47.89%	469,322	
RM980,000 x 52.11%		510,678
Apportioned common capital allowances		
RM85,000 x 47.89%	40,707	
RM85,000 x 52.11%		44,293
Working 2 (W2)		
Capital allowances on leased assets for YA 2009	655,762	
Brought forward	600,000	
Less: Utilised	(333,861)	
Carry forward	921,901	

FOR THE YEAR OF ASSESSMENT 2009, GOODBOY FINANCE SDN BHD'S CAPITAL ALLOWANCES FOR COMMON ASSETS ARE RM85,000 AND FOR LEASED ASSETS RM655,762. UNABSORBED CAPITAL ALLOWANCES FOR LEASED ASSETS BROUGHT FORWARD ARE RM600,000.

TABLE 3: EXAMPLE 5

Goodboy Finance Sdn Bhd Year of assessment 2009	**Leasing business RM**	**Non-leasing business RM**
Profit before tax – all sources	419,480	
Asset A (37,200 - 36,000)	1,200	
Asset B	(10,800)	8,340
Asset C	(21,000)	21,000
Asset D	(19,500)	19,500
Asset E (90,000 - 30,000)	60,000	
Asset F (21,000 - 7,000)	14,000	
Asset G	(60,010)	60,010
Finance leases	(100,000)	100,000
Hire purchase	(709,480)	709,480
Depreciation	290,000	
Common deductible expenses (W1)	510,678	(510,678)
Adjusted income	374,568	407,652
Less: Capital allowances		
Common capital allowances* (W1)	(40,707)	(44,293)
Capital allowances on leased assets* (W2)	(333,861)	0
Statutory income	0	363,359

* Separated for illustration purposes.

WHEN AN AGREEMENT IS A LEASING AGREEMENT (AS IN ASSET A, E AND F), AN ADJUSTMENT IS MADE TO TAKE INTO ACCOUNT THE DIFFERENCE BETWEEN THE TAX INCOME, IE LEASE RENTALS AND THE AMOUNT PREVIOUSLY RECOGNISED IN THE ACCOUNTS.