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FINANCE LEASING

Introduction

Legal Notice 369 of 2005 entitled the ‘Finance Leasing Rules’ (FLR) paves the way for a new vehicle known as Finance Leasing to be recognized by Maltese law and to come into force from a tax point of view as from the year of assessment 2006.

General

A Finance Lease is essentially an arrangement comparable to *mutuum* (or loan for consumption) where the lessor ‘lends’ a sum of money to the lessee for the purchase of an asset to which the lessor formally retains title as security and the lessee returns to the lessor, in several installments, the sum borrowed plus interest and finance charges.

Definition under the FLR

The Finance Leasing Rules (FLR) define ‘Finance Leasing’ as the lease of an asset on or after the 1st January, 2005, that has the following characteristics:-

- the *lessor* is a 'finance leasing company' defined as a company that is (i) licensed to act as a financial institution and (ii) has its trading objects expressly limited to that of engaging in the business of granting finance leases and of carrying out such other activities as are corollary and ancillary irrespective of whether it is incorporated in Malta or overseas;

- the period of the lease is for at least 4 years and is not shorter than the period of the asset's depreciation[1];

- the lessee must pay to the lessor over a number of years the full cost -- or nearly the full cost -- of the asset in addition to a profit/return on the finance provided by the lessor and such other remuneration as may be reasonable in the circumstances;

- the lessee must substantially assume all the risks and rewards normally associated with the ownership of the asset, other than legal title thereto; and

- within 3 months of concluding the finance leasing agreement, notice must be given by the finance leasing company[2] to the Commissioner of Inland Revenue on the prescribed form together with an authenticated copy of the relative agreement.

[1] As established in the Schedule to the Deduction (Wear and Tear of Plant and Machinery) Rules 2001.
[2] Or, if the finance leasing company has been incorporated outside Malta, by the lessee.

From the above definition, it can be seen that 2 important characteristics of a Finance Lease are that:-

- the lessee is not entitled to become owner of the asset during the currency of the lease; and

- the lessor has no obligation to replace obsolete or faulty leased equipment leased during the lease term. Indeed, the burden of obsolescence falls squarely on the lessee.

The FLR state clearly that agreements of (i) hire purchase, (ii) lease purchase agreement, (iii) operating lease and (iv) similar arrangements including sale and leaseback transactions do ***not*** constitute a finance lease.

It should also be noted that, in essence, our definition is substantially similar to the International Accounting Standard number 17 entitled 'Accounting for Leases' that states as follows: '*…under a finance lease substantially all the risks and rewards incident to ownership are transferred by the lessor and thus the lease rentals receivable are treated by the lessor as repayments of principal and finance income to reimburse and reward him for his investment and service*'.

Consequently, the lessee will ultimately be paying to the lessor:

- what it costs to purchase the asset (such costs often including installation costs and training);
- interest charges, since funds may have to be borrowed ahead of rentals being received;

- contribution to overheads; and
- profits.

It can also be seen that, according to the definition contained in the FLR, whether or not title is eventually transferred to the lessee at the end of the Finance Lease is not an essential element of a finance lease.

Nature of a Finance Lease

Having looked at its main characteristics, one can safely conclude that, broadly speaking, a Finance Lease is any leasing arrangement whose principal purpose is to finance the use of an asset for the major part of its useful life. The lessee has the right to use the asset while the lessor retains legal title – the separation of use and ownership for financing purposes is thus an essential feature of a Finance Lease. However, while the lessor retains legal title he is unlike a traditional owner because he cannot usually transfer the ownership of the leased asset, and has no responsibility for their delivery and condition. Instead, the lessor acts rather like a Financial Institution because his only role is that of providing funding for the asset in question. Despite title lying with the lessor, however, the lessee, in practice, still resembles an owner of the asset because under a Finance Lease the cost and responsibility of the asset are placed on him.

Finance Lease versus other types of lease arrangements

(a) Operating leases

In essence, it can be said that, unlike a Finance Lease, an operating lease is one in which the lessee pays rentals only for the period during which the asset is used by him which period is normally substantially shorter than the useful economic life of the asset. Thus, under an operating lease, the cost of the leased asset is not wholly recovered by the lessor out of the rentals receivable during the lease period and the lessor relies on the residual value of the asset to recover the balance of the net investment and to earn a profit.

On the contrary, a Finance Lease involves the payment by the lessee to the lessor of the full cost of the asset together with a return on the finance provided by the lessor, with the lessee keeping substantially all the risks and rewards associated with the ownership of the asset.

In an operating lease, the lessor will be concerned with the maintenance and insurance of the asset, although these costs will usually feature in the rental rate. Thus, typically, in an operating lease of motor vehicles, for example, the lessor will retain the obligation of insuring the vehicle comprehensively against all insurable risks as well as the obligation of servicing the vehicle on a regular basis and repairing it. On the contrary, under a Finance Lease, the agreement will ensure that the lessor will not be responsible for any maintenance, warranties[3] or any obligations ordinarily borne by a lessor. Under a Finance Lease, in fact, the lessor assumes no more than the risk of failure on the part of the lessee to pay

[3] Of peaceful possession, the warranty against latent defects and against risk of loss. In compensation, the lessor would usually assign to the lessee his rights of recourse against the supplier.

the rentals – the ownership of the leased asset constituting the security for the lessor against such risk.

(b) Hire Purchase

It is generally agreed that the distinguishing feature of Finance Lease is that the parties thereto intend the lessee to obtain the maximum enjoyment of the asset without necessarily (though possibly with an option of) being bound to purchase the asset. On the contrary, the real purpose of a hire purchase agreement is to enable the hirer to eventually acquire ownership of the asset once he has paid all the installments which he could not pay for outright.

Tax treatment of Finance Leasing

The stand adopted by the FLR is that Finance Leasing will be treated as follows:-

1. The lessor:-

(a) will be charged to tax on the whole of the rentals (not just the finance charge) since this is treated as income in his hands – in fact, the assets owned by the lessor are capital assets and not stock-in-trade and so he will not be allowed to deduct the cost of purchasing such assets as, for instance, a car dealer would; and

(b) will be allowed a deduction in respect of the wear and tear of the leased asset according to the rules established in article 14(1)(f) of the Income Tax Act [4].

2. The lessee:-

(a) will be entitled to a deduction in respect of the full amount of the lease payments made by him in respect of the leased asset; and

[4] Article 14(1)(f) of the Income Tax Act states as follows:- '*For the purpose of ascertaining the total income of any person there shall be deducted all outgoings and expenses incurred by such person during the year preceding the year of assessment to the extent to which such outgoings and expenses were wholly and exclusively incurred in the production of the income, including………(f) a deduction in respect of the wear and tear of any plant and machinery, and any premises being an industrial building or structure, arising out of the use or employment of such property in the production of the income; and where such property is employed on such terms that the burden of wear and tear thereof falls upon the person making use of the property in the production of the income, but such property does not belong to him, he shall be entitled to any deduction to which he would have been entitled had the property belonged to him: Provided that - (i) the amount to be deducted in respect of premises being an industrial building or structure shall not exceed two per cent of the cost thereof, not including the cost of the land on which the building or structure is erected; (ii) where the total deductions allowable under this paragraph and under paragraph (j) cannot be given effect to in full in any year because there are no profits or gains chargeable for that year from the source of income in respect of which they are allowable or because the profits or gains chargeable from that source are less than the deductions, the deductions or such part of the deductions to which effect has not been given, shall be added to the deduction for wear and tear in respect of that source for the following year and deemed to be part of that deduction, or if there is no such deduction in respect of that source for that year, be deemed to be the deduction for that year and so on for subsequent years; (iii) the aggregate of the deductions made under this paragraph and under paragraph (j), added to the wear and tear, if any, or to such part thereof as may be appropriate, which occurred prior to the commencement of this Act, shall not exceed the original cost, or such part of it as may be appropriate, of such plant, machinery or premises, having regard to the extent to which they were wholly and exclusively used in the production of the income, and - (a) the wear and tear which occurred prior to the commencement of this Act shall be computed at the prescribed rates, and (b) the cost of the land on which the building or structure is erected shall in all cases be excluded from the original cost of the premises;*'.

(b) will be entitled to other deductions properly due under article 14 of the Income Tax Act excluding, of course, the deduction for wear and tear granted by subsection (f) accorded to the lessor.

It should be noted that in the event that the ownership of the asset is:

(i) transferred to the lessee; and

(ii) the lessee makes a payment to the lessor exceeding the '*total agreed annual payments*',

the lessor will be charged to tax on such payment. The lessee will, thereafter, be entitled to a deduction in respect of the wear and tear of the asset according to article 14(1)(f) of the Income Tax Act.

Termination before due date

In the event that a Finance Lease is terminated prior to the expiry of the lease term, the following rules shall apply:-

(a) where the lessor obtains re-possession of the leased asset and subsequently re-leases the asset in question, then, in respect of the new agreements, the lessor will only be entitled to claim in respect of wear and tear the total of the deduction for wear and tear not availed of under the previous agreement/s; and

(b) where the lessor disposes of the asset or takes over the asset against payment of a consideration, he would be required to submit a '*balancing statement*' in terms of section 24 of the Income Tax Act; and

(c) both parties shall be required to inform the Commissioner of Inland Revenue of such termination within 30 days of the date of termination.

Advantages of Finance Leasing

(1) Lessee

In general, it can be said that Finance Leasing offers a number of advantages to the lessee, the more important being namely:-

(a) Finance Leasing, being very easy to conclude, is available more quickly than conventional loans since there is no issue of security as the lessor remains the legal owner of the asset;
(b) since no collateral is required, transaction costs tend to be lower;
(c) unlike a normal conventional loan or hire purchase agreement, Finance Leasing can finance up to 100% of the cost of the asset without the need for any large down-payments;
(d) it offers greater flexibility since the agreement can be structured in such a way as to meet the cash-flow needs of the lessee;
(e) it does not tie up valuable working capital or credit lines, thereby preserving liquidity;
(f) it offers cash-flow benefits since the rentals fixed at the beginning of the lease assist expense budgeting and cash-flow forecasting; and
(g) it provides certainty since it is non-cancellable unlike an overdraft that is repayable on demand.

(2) Lessor

Finance Leasing also offers considerable advantages to the lessor including, for instance:-

(a) ownership of the leased asset giving the lessor very strong security;
(b) relatively simple documentation keeps transaction costs down; and
(c) because the lessor purchases the equipment directly from the supplier, the lessor's mind is put at rest that the funds that were made available were actually used in order to purchase the asset and for no other purpose.

Conclusion

Finally, it should be noted that the Commissioner of Inland Revenue has an over-riding discretion to refuse to recognize a lease of assets as a Finance Lease if he is of the opinion that the finance leasing company and the lessee are in any way related.