CANADIAN INCOME TAX POSTPONEMENT AND
AVOIDANCE OPPORTUNITIES AFFORDED BY THE
LONG TERM LEASE
AN ANALYSIS, HISTORY, AND SUGGESTED SOLUTION.

by

RUSSELL GILL DUTHOIT

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Department of Commerce and Business Administration

The University of British Columbia

Vancouver 8, Canada

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ABSTRACT

The Report of the Royal Commission on Taxation, 1967, stated that tax treatment of leases was of great concern if the system of capital cost allowances was not to be undermined. In spite of this warning, nothing has been done since the repeal of former Section 18 of the Canadian Income Tax Act, in 1963, to remedy the situation. Section 18 was repealed because it was found to be administratively inoperable. A study of current accounting and business practice, of theoretical and research committee recommendations, and of legislation in the United States appears to isolate the reason for legislative difficulties. The premise on which Canadian legislation was based is much too narrow. Only those leases which had purchase options were dealt with. In fact, most long term leases, regardless of whether or not they have purchase options, have most of the attributes of purchases. These attributes include property rights acquired in assets, useful life of assets, equity accumulation in assets, and the fair market value of assets in relation to the present value of total payments required under the lease. In most long term leases, the present value of contract payments, including options, comprises the major part of the fair market value. Current opinion and practice, as expressed by most writers, by research committees, and as evidenced by accounting practice and business acceptance in balance sheet footnoting of long term leases, effectively treats such acquisition as quasi-purchases. In this regard, both theory and practice is far ahead of legislation.
The inequity in the tax treatment of long term leases is much more consequential than is generally realized. Not only is there substantial tax postponement for an ever burgeoning number of realty and equipment leases, but there is 'proper' tax avoidance under the long term lease through depreciation of land for tax purposes, effectively available to lessees, but not available to purchasers. When the thousands of service station and supermarket outlets, and the fact that most are under long term lease in Canada, are considered, tax avoidance from this source alone amounts to many, many, millions of dollars annually. Since leasing is always initially more expensive than purchasing, and the major reason for many leases is tax advantage, it is not unfair to say that legislative inaction contributes considerably to business inefficiency.

This taxation problem is examined under varying aspects, including historical applications of the Canadian Income Tax Act; present legislation and its effectiveness; pertinent tax cases in Canada and in the United States; current accounting and business trends, and Carter Report suggestions. Finally, suggested legislation which embodies the transition of long term leasing to purchasing is proposed. While the proposed solution is relatively simple and concise, it is supported by theory, by practicality, and by operability.
**TABLE OF CONTENTS**

Chapter 1. Introduction to difficulties in taxation of long term leases.

Chapter 2. Difficulties encountered by Canadian legislation.

Chapter 3. Taxation aspects of long term leases.

Chapter 4. History and comments on former Section 18 of the Canadian Income Tax Act.

Chapter 5. Reasons for the prevalence and increasing popularity of the long term lease.


Chapter 7. Sections pertaining to long term leases in the Canadian Income Tax Act.

Chapter 8. Rulings and regulations pertaining to long term leases in the United States.

Chapter 9. Canadian tax cases relating to long term leases.

Chapter 10. American tax cases relating to long term leases.


Chapter 15. Suggested changes in taxation of long term leases.

Bibliography.
LIST OF TABLES

Table I. Comparison of financing costs of owning and of leasing equipment.

Table II. Long term leases shown in Canadian annual reports.

Table III. Number of occurrences of various types of information provided in reports.

Table IV. Long term leases shown in Canadian and in American annual reports.
"With the widespread use of leasing today, the treatment for tax purposes is a matter of great concern if the capital cost allowance system is not to be undermined."

The undermining of our capital cost allowance system is indeed a serious matter, and the source of this drastic statement is not to be taken lightly. Yet, in the debate and furore raised by other recommendations of the Carter Commission, this statement seems to have been forgotten. Why? Is it because former Section 18 of the Income Tax Act, dealing with Lease-Option, Hire-Purchase agreements, was found to be administratively inoperable? Similar tax sections in the United States and in English legislation have not been repealed, and our business methods are not substantially different. Is it because the recommendations of the Carter Commission were impractical? Aside from political implications, critical examination does appear to bear this out. Is it because non restrictive legislation has been recognized as a tax incentive to aid business growth, legislation made easily palatable by the insurmountable administrative difficulties of former legislation? This may be true, but the most likely reason is that no satisfactory solution could be found, and it was felt that

poor legislation would have been made worse by further revision. It is only in the last five years that widespread acceptance has developed for separate presentation of long term leases in the balance sheet, common acceptance sufficient to provide a basis for acceptable tax treatment.

Mention will be made of legislation in Canada, United States, England, Scotland, Australia and New Zealand. Canada appears to be the only country of the above named which either does not legislate against the lessee with a purchase option, or does not require that some long term leases be considered purchases. "... some specific provisions are required to control the tax postponement possibilities under this type of arrangement." The present permissive system allows the following imbalances:

(a) tax discrimination against the owner of assets, in favor of the lessee;
(b) perpetuation of business inefficiencies aided by legislation;
(c) subsidization of lessors, at the indirect expense of lessees, purchasers, and vendors;
(d) the annual loss of millions of dollars in tax revenues; and
(e) weakening of the system of capital cost allowances.

The reason for the ineffectiveness of Canadian legislation, dropped in 1963, is that it had been based on a false premise, the premise that ownership of assets must be involved before these assets can be

2. See Chapters 12, 12, and 14.
3. Report of the Royal Commission on Taxation, Ottawa, Queen's Printer,
treated as purchases. Unfortunately, this premise was contained in the Carter Commission report, which suggested changes probably administratively impractical. However, the death knell of the ownership premise has been sounded by the Research Board of the major accounting institute in Canada, and indirectly by its counterpart in the United States. More important, the death knell has also been sounded by current practices in balance sheet presentation, whereby specific presentation of certain long term leases, and occasionally outright capitalization, is stipulated. In this respect, practice is ahead of legislation.

The astounding growth, the prevalence, and the importance of long term leasing is partially or largely a result of fast and excessive write-offs now allowed. This thesis will examine the long term lease from the standpoint of the lessee; it will examine the background, current business practices, and tax advantages relative to the long term lease; it will attempt to give a reasoned and logical basis whereby tax inequities may be minimized. These inequities are now put in the form of questions, in order to establish at the outset the perspective and tone of later Chapters.

Is it equitable that:

(a) a tax deduction be allowed for the use of land when leased, but not allowed when the land is purchased?

(b) a faster write-off be allowed for improvements (including buildings) when leased than when purchased for the same purpose?

(c) a faster write-off be allowed for equipment when leased than when purchased for the same purpose?

Is it reasonable that:

(d) a system of taxation should be allowed to continue which could, and may, undermine the capital cost allowance structure?

(e) a system of taxation should induce taxpayers to use a more costly method of financing and acquisition of assets?

(f) the public purse should be deprived of very substantial revenues, especially when a considerable part of this revenue would be obtained at no real cost to the business community?

(g) lessors should be given a subsidy at the indirect expense of lessees, purchasers and vendors?
The writer attempted to base this study on former Section 18 of the Income Tax Act, but found, as have many other writers, that the purchase option feature in a lease is only one of many distinguishing features necessary to differentiate a lease from a purchase, and that such differentiation must eventually be based on a broader concept. This concept must answer the question - when does prolonged use of an asset result in de facto ownership? A purchase is a contract whereby the vendor conveys to the purchaser ownership of assets, even though absolute legal ownership may be deferred pending payment. A lease is a contract whereby the lessor conveys to the lessee the use of assets for a term, at a rent. There are an infinite number of ways by which a lessee may be given the use and effective ownership of assets. For example, there need be no purchase option where the residual value of leased assets at the end of the lease term is negligible. The lessee conveyee is given, for all practical purposes, the same benefit as ownership, since the lease extends over the useful life of the asset.

Recent attempts at differentiation have been concerned with

"property rights" available in a lease. No precise definition of property rights has been generally accepted, nor has the extent or amount of property rights been determined which would distinguish a lease from a purchase. Property rights exist when there has been an accumulation of equity, or when control is retained for most or all of the useful life of the asset, or when most of the fair market value is paid or payable under the lease contract.

Former Section 18 of the Income Tax Act attempted to deal with purchase options only. First enacted in the 1948 Income Tax Act, subsequently amended and revised, and finally discarded in 1963, it was designed to restrict to the equivalent of allowable capital cost allowances, fast and excessive write-offs of property normally intended to be purchased. It was primarily enacted to regulate lessee acquisitions, and had little direct effect on the lessor. Where there was deemed to be a hire-purchase, or lease option, the lessee was obliged to disregard the lease payments as expense, and to take capital cost allowances based on total lease payments as required under the lease, plus the final option payment. The lessor would also take capital cost allowances on the same asset until the option was exercised, at which time, for his purpose, a sale was made.

Excessive write-offs of property, which Section 18 attempted to remedy, were exemplified by the fast growing sale and leaseback methods of financing as practiced by large oil companies to finance their service stations, by large grocery supermarket chains which were
financing their supermarkets in the same manner, by sale and leasebacks of non-chain commercial, industrial and large residential properties; and by faster write-offs of major equipment acquisitions. Tax minded investors and builders were very aware of the fact that deductible lease payments on real estate covered not only the use of buildings, but also the use of land, otherwise non-depreciable. The natural advantages of leasing, including beneficial cash flow, availability of financing, servicing, by-passing of restrictive borrowing terms, and other advantages to be mentioned later, would have made this form of financing increasingly attractive to the lessee. When coupled with the very considerable tax advantage, the result was an explosion in the leasing field. This explosion was foreseen by the tax authorities.

From May 31st, 1954 to December 31st, 1963, Section 18 grew fivefold in descriptive space required, necessitated by revisions particularly dealing with non-arm's length and fair market value features. Eventually the entire Section had to be repealed. The lease was far too versatile an instrument to be held back by limitations on but one of its many variations.

Recommended legislation must now deal with the enormous and increasing magnitude of long term lease transactions, and with the consonant problem of whether or not a deduction should be allowed for land use. The increase in leasing transactions as a method of financing and
acquisition has been truly phenomenal in Canada and in the United States. In Canada, during the last two decades (1950 - 1970), there has been greater than a hundredfold increase in the dollar volume of leasing. In the United States, the American Institute of Certified Public Accountants has stated that "It is estimated the industrial leasing of machinery and equipment has risen from an annual volume of $10,000,000 per annum a decade ago to around $1,000,000,000 today." That was in 1964! A more recent estimate is that by 1972, equipment leases will total $3,000,000,000. Large as this amount is, it is only a small fraction of amounts involved in realty leases. It has been estimated that one company alone leases property valued at roughly $1,000,000,000. It would be conservative to say that over 50% of all major corporations in North America use leasing as a financial device. In Canada, of 325 public companies chosen as a representative sample, 124 made reference to long term leases in their 1968 annual reports. The writer examined 135 annual reports for the years 1969 and 1970, and found the proportion in the United States of companies leasing assets to be much greater than in Canada.


Sufficient data has not been available on which to base, with any degree of accuracy, the amount saved in taxes annually by the use of lease deductions rather than capital cost allowances. However, an unsubstantiated estimate for Canada would put the annual savings in the neighborhood of $100,000,000. Regardless of its magnitude, the cost to the federal treasury is growing by leaps and bounds each year.

There is a much greater tax inequity involved in the leasing of real estate than in the leasing of equipment, which accrues from the extended period of realty leases, and the ability to depreciate land. Should, then, a deduction be allowable for land use? Every business enterprise pays for the land it uses, either by rental, cost of borrowing, or cost of equity capital. For tax purposes, the entire cost of land use is allowed by rental, partial cost of use is allowed by borrowing, (where borrowing is not 100% of the land value), and no cost of use if allowed by ownership. "Perhaps the most popular concept today emphasizes that assets


4. See Table IV, Chapter 12.

5. See Table III, Chapter 12.

6. The total value of income producing land in Canada under long term lease, including land used by service stations, supermarkets, shopping centres, and other outlets, probably exceeds $2,000,000,000. Improvements thereon are a multiple of this figure. These two sources, plus equipment, would appear to justify the estimate.
are rights to future service potentials or rights to expected future economic benefits." These rights must be paid for, including the right to use land. The reason given by tax authorities for allowing no deduction for land use is that land does not depreciate. However, the cost of capital to pay for the land is an annual expense, whether equity capital or otherwise, even though not always allowable for tax purposes. The businessman cannot be blamed for wanting a maximum deduction; indeed, he should be questioned if otherwise. This problem will not be dealt with here, but it is obviously a vital consideration in long term leasing.

CHAPTER 3

TAXATION ASPECTS OF LONG TERM LEASES.

Before proceeding further, the meaning of a lease, and the more important conditions, types and terms therein applicable to taxation must be described. No attempt is made to be comprehensive.

A lease, according to Anger, is a "conveyance of property for a definite period, or at will."¹ Websters Dictionary defines a lease as "a contract by which one conveys real estate for a term of years, or at will, usually for a specified rent."² The lease of other than real property is, terminologically, of recent innovation. The term "hired", or "hire", as where applicable in "hire-purchase", was used for the lease of property other than real estate, but is seldom used now. A lease is now the connotation applicable to all leasable assets.

The equipment lease with a purchase option differs legally from a contract of sale payable by instalments. In the latter, the purchaser has no option to terminate the contract by returning the chattel, whereas in the former case he has. The instalment contract usually

provides that upon default in payment of any instalment, the owner may retake possession. In both Australia and England, the hire-purchase financing method came with the invention and sale of the sewing machine, a hundred years ago.

The lease-option could be a lease with any one or more of a variety of options. However, in common usage, it generally refers to a lease with a purchase option, which is granted upon satisfaction of certain conditions. The purchase option is usually for a stipulated price, and can take place after a stipulated period of time, commonly at the termination of the lease period, before renewal periods.

The development of the rejectable purchase offer in realty leases has, in many places, superseded the purchase option benefit, and is undoubtedly a reason for the repeal of Section 18. It gives the lessee many of the advantages of a purchase option without a contractual obligation which could be construed as a purchase. In effect, at the end of a stipulated term, the lessee offers to purchase the leased property for a pre-arranged price. Should the lessor refuse the offer, the lessee has the option of cancelling his lease. The rejectable purchase offer was developed in the United States by large grocery supermarket chains, who stopped using a lease with a purchase option because of the adverse tax situation. In the United States, a lease with a purchase option is still apt to be construed as a purchase by revenue authorities. Where,
because of population shifts, or other factors, a supermarket was found to be uneconomic, a non-cancellable lease of say twenty five or more years could be a severe liability. The rejectable purchase offer was usually designed to give a fair market value, or better, where the offer was to be made. The supermarket could then sell the property, take its loss, if any, and not be saddled with further lease commitments. The lessor would in all likelihood accept the offer, as he would make a bonus over and above his original projected return on investment. Should he not accept, he would have an unleased building on his hands.

Long term leases are to be distinguished from short term rental contracts. Such contracts, made on a daily, weekly, or monthly basis have a well established tax treatment which is not likely to be changed. Amounts paid, for the most part, are allowable expenses. There is no accepted criterion to establish when a short term lease becomes long term. From an accounting point of view, a term in excess of one year is not current, and may be presumed to be long term. In the equipment leasing field, terms of three and five years are standard, while from a realty standpoint, "long term leases may be classified as those covering a period of from ten to ninety nine years or more."\(^3\)

The Research Committee of the American Institute of Certified Public Accountants has suggested a three year term as the difference between a short term and a long term lease. There are many variations in lease terms, particularly in larger leases, which are often custom made to fit the circumstances. One or more renewal periods are common in both equipment and realty leases. There is a good reason for this. In the equipment field, the lessor will ordinarily require that his investment, plus a fair return thereon, be returned during the period of the main lease. During this period, the lease is often non-cancellable, and the major part of the useful life of the equipment will have passed. Thus renewal options are often for a small fraction of the amount of the original rental. Where options are not exercised, the residual value of the asset is mostly extra profit to the lessor.

Realty leases are for much longer periods. The value of existing improvements is normally amortized over the period of the main lease, and it is recognized that there may be a larger residual value due to the value of the land, and in many cases, the remaining value of the improvement. Renewal options are often a matter of negotiation; the effects of inflation, depreciation, population and business trends over long periods are difficult to forecast. Where the lease is non-cancellable, the lessee will usually have the benefit of a lower periodic payment, because he is normally contracting for the use of the property over most of its useful life, and because the lessor will recover his original investment,
plus a return, by the surety of a binding contractual obligation. A non-cancellable lease is one criterion used to support the concept of a purchase as distinguished from that of the rental of an asset. This criterion is recognized by legislation in the United States, and could be a factor under Sections 12 and 137 of the Canadian Income Tax Act for the same purpose, although the possibility in normal transactions is remote.

The "sale and leaseback", or simple leaseback, is a financing transaction with the use of a long term lease, where properties are sold to acquire cash, and then leased back in order to obtain use of the asset. Service stations and supermarkets are commonly financed by variations of this method. For example, property to be leased is bought or constructed by the lessor, to the specifications of the lessee, under an agreement to enter into a lease contract. Prior ownership may be involved, where the lessee buys land and constructs the property to be leased, then sells to the lessor under a leaseback arrangement. Usually the lease is long term and non-cancellable. The leaseback was probably first used to a significant extent by oil companies for acquisition

and operation of service stations. It was used in a different manner to what it is today, when there are few independent stations. Oil companies approached independent owners, offering to lease the premises, subject to a leaseback under a sub-lease to the owner, at a rent less than the rent payable under the first lease. The initial rent payable by the oil company was a deductible expense, and the net loss arising was a small cost to secure a new outlet. Where the sub-lessee in turn leased to further tenants, a complicated series of priorities arose.

A "net lease" is a lease which requires the lessee to pay to the lessor a fixed rental, usually covering the lessor's amortization and expected return on his investment. The lessee is responsible for all other charges related to the property, such as realty taxes, heat, light and water, maintenance and repairs. A "net net lease" may apply where the lessor is a non-resident, and the lessee pays the withholding tax, or the Canadian income tax otherwise payable. The lessor pays his income taxes, and if there is a mortgage on the property, the interest and amortization thereon.

Property rights applicable to long term leases are much discussed, but ill defined. Practically, the concept is used to justify the inclusion or exclusion from the balance sheet of the lessee's asset. It is a non-legal concept, but very pertinent to this thesis. Briefly, property rights come into being when the use of assets is sufficiently
substantial to give some of the attributes of ownership. Accounting Research Study No. 4, of the American Institute of Certified Public Accountants, (not entirely adopted), states that "the entire amount of rentals is probably a payment for property rights in a lease containing all of the following provisions:"

1. Length of lease - where the lease covers substantially the entire useful life of the leased property.

2. Option at termination - where the lessee may buy the property at the termination of the lease for a nominal price.

3. Cancellation provisions - where the contract is non-cancellable.

4. Rent - where the lessee pays fixed amounts (as distinguished from variable amounts) sufficient to return to the lessor his investment in the property plus a fair return.

5. Taxes, insurance, maintenance - where these and other similar costs are to be paid by the lessee.

On the other hand, only a trifling portion of the rentals would constitute payment for property rights where:

1. Length of lease - the lease covers a very short period of time.

2. Option at termination - no options are given.

3. Cancellation provisions - the lease may be cancelled before termination.

4. Rent - where the lessee pays fixed amounts (as distinguished from
variable amounts) significantly lower than similar purchase payments, or where levels of rent are varied according to competition.

(5) Taxes, insurance, maintenance - the responsibility of the lessor.

The above criteria appear to negate assumptions that a purchase option is required before purchase is evident, and that legal and de facto ownership are inseparable. Proponents of balance sheet presentation for long term leases assume that the fundamental purpose of business property is to earn income, and that the balance sheet should reflect this characteristic. When the ability of an asset to earn income is decreased, the cost of the asset should be correspondingly decreased by depreciation, depletion, amortization or obsolescence. When an income producing asset is incontrovertibly intended and available for the earning of income for most of its useful life, it should be shown as an asset, at cost less decreases in earning power. With leased assets, the cost would be calculated by determining the present value of contractual payments. For tax purposes, terminal loss provisions would be exercised when the asset was returned to the lessor, or otherwise disposed of.

The tax implications of property rights can be developed by use of an example. Assume equipment is required, with a useful life of

three years, and no residual value. This equipment can be purchased on monthly instalments over the remaining thirty five months. The equipment can also be leased, with no purchase option, for the same price and for the same payments. The two contracts are virtually identical, excepting claim to legal ownership. Most accountants would show the asset on the balance sheet, if purchased, but not if leased, unless by balance sheet footnote, and only then if considered sufficiently important. The difference in tax treatment is immense. Purchase requires capitalization, with Class 8 depreciation at the rate of 20% per annum on a diminishing balance. The lease would be written off at 33 1/3% per annum, on a straight line basis. When it is considered that working capital is worth from 10% to 20% to most enterprises, that the expense differential is cumulative in effect, that the cash flow benefits resulting from tax savings (and in most other cases from cash retention of a down payment) are substantial, it is easy to see why enterprises are willing to pay for the higher cost of leasing. Terminal loss provisions will eventually put an end to the tax advantage, but even here a full loss may not be claimed if there are other assets in the same class. The tax disadvantage caused by purchasing would be prolonged for many more years. This is why the Carter Commission suggested changes in the terminal loss provisions in the same section that lease option legislation was mentioned.

Inequities such as those described are serious. They inevitably
lead to exasperation with the laws, to other tax reduction considerations, to unproductive but often profitable time and money spent in outwitting the tax collector, to an undermining of the capital cost allowance system. This, coupled with the very high loss in revenues, should be a practical incentive to serious consideration of property rights by tax authorities.

Concurrently with property rights must be considered the offsetting contractual liability which would be required to be shown on a balance sheet if property rights in a lease were to be capitalized. The case for showing this liability on the balance sheet is so strong, and has been advocated by so many accountants subsequent to the infamous ruling of the Accounting Principles Board of the American Institute of Certified Public Accountants in 1964, that a turnabout question is probably more powerful than mere advocacy of balance sheet presentation of property rights. Where an undisputed contractual obligation exists, should not the liability and asset be shown on the balance sheet? The reason given for exclusion by the Accounting Principles Board, severely criticized since publication, was that a lease contract is wholly executory in type,

meaning that all of its provisions pertained to the future. A purchase with no down payment is also wholly executory in type, and the asset and liability must be shown on the balance sheet. The Accounting Principles Board did find it necessary to make exceptions (as matters of opinion only) for non-cancellable leases and purchase options.  

7. Accounting Principles Board, op. cit., Opinion No. 5.
CHAPTER 4.

HISTORY AND COMMENTS ON FORMER SECTION 18, CANADIAN INCOME TAX ACT

This Chapter has been placed after that on lease explanation, in order that some of the problems might be more readily comprehended. When Section 18 of the Canadian Income Tax Act was first introduced in 1948, it consisted of two paragraphs, and was wide open to misuse and misinterpretation. The paragraphs are reproduced below:

Section 18(1) "A lease-option agreement, a hire-purchase agreement or other contract or arrangement for the leasing or hiring of property, except immovable property used in carrying on the business of farming, by which it is agreed that the property may, on the satisfaction of a condition, vest in the lessee or other person to whom the property is leased or hired shall, for the purpose of computing the income of the lessee or other such person, be deemed to be an agreement for the sale of the property and rent or other consideration paid or given thereunder shall be deemed to be on account of the price of the property and not for its use; and the lessee or other person in whom the property may vest shall, for the purpose of a deduction under paragraph (a) of subsection (1) of Section 11, be deemed to have acquired the property at a capital cost equal to the price fixed by the contract or arrangement minus the aggregate of all amounts paid by him."
Section 18(2) "Where a person is deemed under subsection (1) to have acquired property under a contract or arrangement and the contract or arrangement is subsequently rescinded or determined, he shall, for the purpose of Section 20, be deemed to have disposed of the property for the price fixed by the contract or arrangement minus the aggregate of all amounts paid by him under the contract or arrangement on account of the rent or other consideration." \(^1\)

Section 18 was amended in 1950, \(^2\) and in 1954 \(^3\) Section 18(3) was added, and Section 18(1) was amended, largely to account for non-arm's length provisions. Finally, as of December 31, 1963, \(^4\) Section 18 was repealed in its entirety, applicable to the 1963 and subsequent taxation years. At the same time, transitional provisions to account for lease-options established prior to 1963 were enacted. \(^5\)

Before Section 18 was repealed in 1963, it was a complicated piece of legislation. Its principal provisions are paraphrased, with comments as follows:


\(^2\) Ibid., 1950.

\(^3\) Ibid., 1954.

\(^4\) Ibid., 1963.

\(^5\) Ibid.
(1) An agreement for the leasing of property (except immovable property used in farming) by which, on satisfaction of a condition, the property may vest in the lessee or in a person with whom the lessee does not deal at arm's length, shall, for the purpose of computing the income of the lessee, be deemed to be an agreement for the sale of the property.

The basic error of this legislation, which could not be overcome, was the requirement of a purchase option, or that somehow, legal ownership be involved. The versatility of leases, whereby virtual ownership is given by prolonged use, remains much too effective to be limited by this one restriction.

(2) The rent paid shall be deemed to be on account of the price of the property, and not for its use.

The courts attempted to preclude applicability of lease contracts under Section 18 of the Income Tax Act by attempting to distinguish between "paid" and "payable".

(3) The lessee who was not at arm's length with the lessor at the time the contract was entered into, shall be deemed to have acquired the property at the capital cost to the lessor.

By and large, this was a fair provision, although some hardship may have resulted from bona-fide sales to persons not acting at arm's length.

(4) Lessees dealing at arm's length shall, for the purpose of capital
cost allowances, be deemed to have acquired the property at a capital cost equal to the aggregate of the rents payable under the contract, plus the last option price. The capital cost of depreciable property is deemed to be the price fixed by the contract (being the aggregate of the rents payable under the contract, plus the last option price, minus the fair market value), at the time the contract was entered into, on any non-depreciable property.

This subsection resulted in probably thousands of mostly spurious transactions, some allowed, giving exorbitant tax advantage. The legislators completely overlooked the aspect of present value, and took the aggregate of all payments made, with no interest calculation, to be the equivalent of present value. This, of course, resulted in highly distorted figures. An example, based on the Harris case, would be a building, costing $10,000, with rentals of $100 per month, under a ninety nine year lease, with a purchase option at the end of the period for $1,200. Total payment would amount to $120,000, on which allowances would be based. Depreciation for the first year could amount to well over $10,000, more than the total cost of the building. Moreover, the possible terminal loss, which could be applicable to other income, could be very large. The courts, in their endeavour to uphold equity, made what appeared to be highly contrived rulings.

(5) Where the lease agreement is subsequently rescinded without the
property having vested in the lessee, he shall be deemed to have disposed of the depreciable property for the capital cost at which he was deemed to have acquired it, less the rents paid. If the aggregate of rents paid exceed the deemed capital cost of the depreciable property, the excess will be deemed to have been paid for the use of property in that year.

Here we have the terminal loss provision, the latter part of which could apply where there has been disagreement over the respective costs of depreciable improvements, and undepreciable land.

(6) Where there are several times at which options can be exercised in the lease agreement, and one of the earlier options is exercised, then the lessee shall be deemed to have received at the time the property vested in him an amount as proceeds of disposition of depreciable property equal to the capital cost at which he was deemed to have acquired all the property, minus all amounts paid on account of rent and option price after deducting the fair market value of non-depreciable property at the time the contract was signed. If the amounts paid, less the fair market value of non-depreciable property at the time of the agreement, exceed the capital cost, then the amount of this excess is added to the otherwise capital cost for the purpose of calculating depreciation in the future.

This subsection was a later attempt to cover several loopholes, with the introduction of fair market value and rules for more than one purchase option period. In the latter sentence, capital cost refers to that established in the lease for depreciable assets. Where total rents paid, less the market value of land, exceeded this established capital cost, then the excess would be added to the capital cost.

(7) The lessee shall be deemed to have disposed of the property at the time the option was exercised, at its undepreciated capital cost to him, where it is agreed that upon exercising the option the property might vest in a person not dealing at arm's length with the lessee and the property has vested in that person. The capital cost of the depreciable property to the new owner shall be the same as that deemed to the lessee.

This non-arm's length provision attempted to control inter-related transfers.

(8) Rent or other consideration does not include any amounts paid as, or on account of, property taxes or repairs in respect of the property.

If "other consideration" had been extended to include interest, as well as property taxes and repairs, much more equity would have resulted. For example, if a fifty year 8% lease is considered, the interest paid is over three times that paid on principal.
CHAPTER 5.

REASONS FOR THE PREVALENCE AND INCREASING POPULARITY OF THE LONG TERM LEASE

While income tax advantages are a major reason for many long term leases, other reasons, both objective and subjective, are involved in the final decision to lease or to buy. The principal reasons for leasing are given under two sub-headings, those directly related to, and those indirectly related to tax benefits.

Advantages Directly Related To Tax Benefits.

(1) Net cash flow, always an important consideration, is usually increased by the use of long term leases. Not only is the down payment minimal, but periodic payments, even when larger than those under conditional sales contracts, are fully deductible, giving maximum tax reductions.

(2) The leasing of real estate involves the leasing of land, and improvements thereon. Whereas no deduction is allowable for land under the capital cost allowance system, total lease payments are deductible, with the effect that land, as well as improvements is amortized. The small size of present value considerations over long periods of time assure that the major portion of the cost of land will be written off even where land does not revert to the lessee. For instance, the present value of
an amount payable in 30 years, at 8% compound interest, is less than 1/10th of the absolute total. The higher the land value in proportion to the total value of the real estate, the higher will be the tax benefit received. The higher the income tax bracket of the corporation or individual, the greater will be the tax benefit received. Where a corporation or an individual is in the 50% tax bracket, and leases land under a long term lease, then, as compared to a purchase, the government effectively pays for approximately half the land value.

(3) The longer the term of the lease, the less will be the present value of the land. The present value of land under a long term lease, where a high interest factor is given for the use of working capital, would be but a small fraction of today's fair market value.

(4) The value of the larger current tax deductions allowed under a lease is augmented by the value of the discount rate. A deduction now is worth more than a future deduction, assuming constant tax rates.

(5) The value of the larger current tax deductions allowed under a lease is augmented by the effects of inflation. A deduction now is worth more than a future deduction.

(6) Terminal loss provisions may necessitate a purchase being amortized, for tax purposes, for many years after its useful life. This would not be the case under a lease.

(7) The capital gains tax enhances the value of a leaseback device, one which involves considerable tax benefit to the lessee, including the
freezing of asset values. It is the increasingly popular leaseback of property to a trust. Assets are transferred to a family trust, which then leases them back to the person establishing the trust. In the United States, such rental deductions have been held valid for tax purposes.

(8) A device to reduce estate taxes of United States citizens is a non-arm's length sale and leaseback of property purchased in Canada. Foreign real estate is not included in a decedent's estate for tax purposes in the United States.

(9) The development of the rejectable offer, previously described, is a clause so powerful from a tax point of view that it was probably influential in the decision to repeal Section 18 in 1963. It could not be deemed to be a purchase option, since there is no requirement that the lessor need accept the offer.

(10) Large organizations, such as grocery supermarket chains, and large oil companies, have little trouble obtaining 100% financing, or better, for their proposed new outlets, at very low rates. They use the tax advantages of long term leases to their limit. These firms will normally find their own location, purchase the land, arrange construction of required improvements, and, with the use of their credit rating, obtain the highest possible mortgage on the best terms available. This is commonly 90% of cost or more, with 100% mortgages not unusual. The remaining equity in the property will then be sold, with a leaseback
arrangement, often to an individual in a very high tax bracket, who will be more than glad to accept a low interest return, and low cash pay-outs, in order to secure the astounding tax benefits. This lessor will be able to offset high interest deductions, full depreciation, and operating expenses against his comparatively low cash returns, to show such huge paper losses that the tax savings alone will pay for his investment in a very few years, and he could afford to give the property away should recapture of depreciation prove overly troublesome.

(11) The sale and leaseback of older but substantial real estate offers, for the time being at any rate, more tax benefit in Canada than in the United States. Continuous ownership limits depreciation to book value (based on cost less depreciation); sale and leaseback allows the vendor to take advantage of increased market values, and although capital gains may reduce the proceeds from the sale, the rent deduction will be much higher. Many firms in the United States have paid a relatively small capital gains tax in order to secure the larger future deductions.

(12) A tax advantage may be gained in a sale and leaseback even where the sale takes place at a book loss; terminal loss, and subsequent higher rental payments may more than offset the loss.

(13) For tax purposes, the expenses of the lessor may be increased, and net outlay decreased by obtaining a mortgage on leased premises, or obtaining a loan on leased equipment. In Canada, it is quite possible to
obtain a mortgage on leasehold land. Under the 1954 National Housing Act, insurable lending on leasehold land is allowed if the lease term extends beyond the maturity date of the mortgage for a sufficient number of years to provide security which is adequate, as determined by the Central Mortgage and Housing Corporation. In Quebec Province, the only type of lease which may be mortgaged is an emphyteutic lease, used only in that province. It cannot be for less than nine years, nor for more than ninety nine years, and the lessee agrees to make certain improvements, which revert to the lessor.

(14) A sale and leaseback may preserve a loss carryover which is about to expire because of the five year limitation on carryovers; a sale and leaseback at a gain may be effected primarily for tax reasons, in order that the gain may be offset against the loss.

(15) A tax advantage is often obtained by the long term lease with assets which would normally have to be purchased, such as specially constructed equipment for a particular location or job, and heavy equipment flown in to otherwise inaccessible locations, such as mines. Rather than purchase of this one time use, or one location use type of equipment, the lease will provide a faster write off, and an improved cash flow position. It is not the responsibility of the accountant or auditor to record this obviously intended purchase as a purchase. He must interpret the Income Tax Act as it is written. It is interesting to note that if the recommendations of the Carter Commission were implemented, the form of the
contract, rather than the use of the assets, would appear to determine the nature of taxation, and such assets as those above noted might continue to enjoy tax benefits.

(16) When acquisition of a high cost asset is contemplated, sale of shares for financing purposes may be considered. The alternative of leasing has several advantages over this procedure; the cost of leasing may be less than that of issuing and selling shares, and subsequently, dividends paid on the shares are not a deductible expense.

Advantages Indirectly Related to Tax Benefits.

The following advantages, while not directly related to tax benefits, nevertheless must often be taken into consideration in the final decision to purchase or to lease. In many cases, their importance may exceed that of tax benefits.

(1) The lessee can borrow the full amount of the cost, less the first payment, whereas with conventional debt financing, the maximum that can be borrowed varies, but is commonly from 67% to 90% of the cost of the asset. The extra risk taken by the lessor is one reason why lease rates are higher than conventional mortgage rates, but this disadvantage may be more than offset by the increase in borrowing, and by other advantages.

(2) There are still corporations, especially of European origin, which are adamant in their refusal to show long term leases in any manner on the balance sheet. The balance sheet is not affected by leaseback financing to the same extent as by debt financing. No long term debt appears among the liabilities, and ratio calculations are misleading in favor of such lessees. Footnoting mitigates this advantage, and this practice is followed by what appears to be an increasing majority of corporations, but disclosure on the face of the balance sheet is still rare.

(3) The lease may be preferable where the residual value of the asset is expected to be small or negligible, where substantial reduction in value may occur with a cancellable clause, where severe usage or technical obsolescence is a factor, or where risks and fear of ownership, as with new and untried equipment, are a factor.

(4) Within the last twenty five years, the pride and stability of ownership in the decision process has become secondary to the concept of rate of return on investment. The consequent widespread usage of long term leases by even the largest of corporations has tended to reduce the overall cost of leasing, and to make this method of financing more acceptable.

(5) There may be some merit to the argument that in a period of shortage of capital, and high interest rates, leasing helps to alleviate the violent swings characterized by periods of depression and prosperity.
Restrictions on the acquisition of fixed assets, as with heavy
debt corporations, which must keep within budget and capital expendi-
ture limits, make leasing at times the only means of acquiring assets.
In the same category, but not directly linked with tax advantage, are
government agencies such as school districts.

Lessor services, such as repair and maintenance, especially
where the lessor-manufacturer is involved, are often of importance
in the decision to lease, as with computer installations. Also, the
buying advantages of large lessors can make prices more competitive.

The cost and availability of insurance may be an important factor.

Leasing increases the total pool of credit available to a company
or to an individual.

An advantage of equipment leasing is that at the end of the primary
lease, when the lessor has usually recovered the majority of his cost,
most leases are renewable at much decreased levels of rent.

The leasing of assets may obviate the need for permanent financing
arrangements which might necessitate more financing than required.

Long term leasing allows retailers and manufacturers to concen-
trate on principal business activities without ownership responsibilities.

A recent innovation in the mortgage market has enhanced the popu-
larlity of long term leases. To counteract the effects of inflation, and
to increase rates of return, large insurance companies have been de-
manding a substantial minority equity ownership in property before
they will advance desired mortgage monies. This reduces the rate of return to the owner, and the incentive for ownership.

(14) The following quotation from a well known realtor could apply either to tax or to non-tax advantages: "...we have found that a custom made lease, tailored to fit the circumstances of a particular case, with adequate renewal options, is tantamount to ownership."²

Disadvantages Directly Related to Tax Benefits.

(1) Where there is not a purchase option, there usually is a loss of reversionary interest, or the residual value of the asset after termination of the lease. Where there is a purchase option, there is the danger that it will contravene the provisions of Section 12 or Section 137, or the wording may be such as to make it non-differentiable from a conditional sales contract. This danger must be qualified, for practical purposes, by the interpretation of the Income Tax Act as seen by accountants who prepare the financial statements. As always, it is their interpretation which is of primary importance, not that revealed in the few cases examined in detail by the understaffed department.

Since 1963, the legal form of the lease contract is probably of increased importance. The intent of a transaction, a matter of opinion, will likely defer to the legal form of the contract for tax purposes.

(2) Deductions for depreciation and interest are not allowable when
property is leased. In some few cases, these may equal or be greater
than rental deductions. Close examination may reveal that tax savings,
particularly with shorter term leases, such as with autos and computer
equipment, accrue from timing of deductions, and may not warrant the
extra cost of the lease.

(3) To the extent that the enforcement of existing government regula-
tions are influenced by the United States, then rules, regulations and
American tax cases from south of the border, setting restrictive guide-
lines on tax postponement devices available through the long term lease,
will be reflected by Canadian authorities.

(4) The following factors, if contained in a lease, may make it subject
to interpretation as a conditional sales contract under Sections 12, 17,
and 137:

(a) Rental payments materially exceed the fair rental value of the pro-

perty.

(b) Part of the rent is designated as interest, or can be so recognized.

(c) The purchase price is mentioned or referred to, and part of the
rentals apply to this price.

(d) Title to the property is given to the lessee when a specified amount
is paid by the lessee.

(e) An indicated purchase option price is only nominal in amount.
(5) From a strictly legal point of view, many long term leases may well be interpreted as purchases, and the differentiation from conditional sales contracts hangs on not much more than a thread. An authoritative digest of Canadian law states that "......if it appears that the parties have agreed upon the essential terms of the sale, a mere intimation of a desire that the agreement shall be embodied in another document of a more formal nature, or the expression of a condition which is a condition of the contract itself (such as approval of the title), does not prevent it from being enforceable." Similarly, "To determine the true character of the contract, its substance and not its words are looked at." Also, a conditional sales contract appears to be just as executory in nature as a long term lease, by definition. "A conditional sale of a chattel is a sale in which the transfer of the title to the thing sold or the buyer's right to retain it is made dependent upon the performance of a condition; and notwithstanding its delivery to the buyer, the binding effect of the sale depends upon due payment or other performance by the buyer, so that meanwhile the ownership is not vested in him." The American interpretation of executory

4. Ibid., p. 221.
5. Ibid., p. 222.
contracts would not be on strong ground in Canada.

**Disadvantages of Long Term Leases Indirectly Related to Taxation.**

(1) A long term, non-cancellable lease implies loss of freedom to withdraw from the investment, and in this respect there is no advantage over a purchase.

(2) The cost of a lease before tax considerations, almost invariably, is much more than that of a purchase with a loan. In a net lease, the interest factor is from 1/2 of 1% to 2% higher than would be set on a conventional loan. Reasons for this higher cost, as found by Vancil and Anthony, are greater risk of loss, higher administrative, legal and clerical costs, the value of ancillary advantages of leasing, and the restricted market for the sale of leases as compared to that for the sale of debentures.

(3) The cloak of secrecy concerning balance sheet presentation of long term leases has been partially removed by the growing acceptance of accountants and auditors of the need to show details of these leases at least in footnotes to the balance sheet.

(4) Leaseback transactions and valuations are seldom used for appraisal purposes. They "seldom demonstrate an economic rental." 7

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particular, such leases on single occupancy buildings are "designed more for the purpose of gaining a tax advantage, 8 than for competitive rentals.

(5) It is not necessary to lease property in order to have services independently provided by the lessor or vendor. Such services are often obtainable elsewhere.


8. Ibid.
CHAPTER 6.

BUSINESS TRENDS AND TAX EXAMPLES

(A) Sale And Leaseback Of Improved Property, Book Value For Taxation Purposes In Excess Of Market Value.

This type of tax advantage is shown first in order to illustrate the phenomenal tax savings which can accrue from leasing. In most recent sales, depreciation has been more than offset by inflation, and book values are lower than market value. However, it is not uncommon to find book values in excess of market values, and occasionally, much in excess. It is of interest that the capital gains tax, when it comes into effect in Canada, will create situations advantageous for this type of tax gain, and a number of similar transactions can be expected.

May Department Stores Inc. \(^1\) sold a large parking garage, with a book value of $2,500,000, and a market value of $460,000, for $460,000, with $100,000 cash and a $360,000 mortgage. It was then leased back for twenty five years at $32,000 a year, and the loss of over $2,000,000 was claimed as a terminal loss. The claim was contested, but allowed.

(B) Sale And Leaseback Of Undeveloped Property.

A classic method of obtaining tax advantage is by sale and

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leaseback of unimproved land on which improvements are contemplated, the leaseback to include the value of the improvements. The total lease payments would be an allowable expense, whereas with ownership, the value of the land could not be claimed as an expense. The lessee has the benefit of the immediate use of cash (otherwise payable for the property, if not owned, or the cash received from the leaseback), and can claim large tax deductions. He must pay a required rate of return to the lessor, and may lose the reversionary interest in the land. This type of transaction is now more advantageous in Canada than in the United States, because in Canada a purchase option need not turn a lease into a "deemed to be purchase", and consequently loss of the reversionary interest is not necessary for tax benefits to be realized.

(C) Sale And Leaseback Of Improved Property Involving Land Only.

The following example of a large unit transaction in the United States could equally well apply in Canada. A thirty-three storey office building, including land, was purchased for $6,000,000 in cash. Partial financing could have been obtained by a mortgage of $3,750,000, with payments of $244,000 annually, or by a sale of the land for the same price, with leaseback payments of $244,000 annually, and extended renewal options at $100,000 annually after 27 years (the amortization period of the mortgage). From a legal point of view, ownership of land includes ownership of improvements thereon. In this section, the meaning of
"land only" includes land plus improvements on which there are no subordinated claims. In the absence of tax advantage, it would appear foolish to pay rentals for 27 years and not own the property, when it could be owned with the same payments. However, the lease method was chosen. When mortgaged, an average of $139,000 would apply to debt reduction, not a deductible expense. This would mean that roughly $70,000 annually would be gained taxwise by leasing. This amount, set aside and invested over the 27 years, would produce the $3,750,000 with an interest rate of less than 5%. If, at the end of the period, the land (and improvements) were worth less, the investment would have been made worthwhile; if it was worth more, the renewal options at $100,000 would be very valuable, and there was every likelihood that a re-investment rate of greater than 5% could be obtained.

(D) Sale And Leaseback Involving Land And Improvements Separately.

This method of improving property values at the expense of the government has been used a number of times. Probably the most famous case was the purchase of the Empire State Building in New York, and its immediate redivision into component equities, netting an immediate gain of over $2,000,000. The transaction was essentially as follows:

(a) The land and the improvement thereon were evaluated separately.
(b) A maximum mortgage was obtained on the land alone.
(c) The land was placed under a long term lease, and the leasehold interest sold.
(d) A maximum mortgage was obtained on the improvement.
(e) The building was placed under a long term lease, with cash and a leasehold interest being obtained by sale and leaseback.
(f) The leaseback equity in the building was sold.
(g) The management contract for the building probably was sold.

A similar type transaction for a property purchased for $2,000,000 in cash, with land worth $600,000, and the improvement $1,400,000, could be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage on Land</td>
<td>$400,000</td>
</tr>
<tr>
<td>Land Sale</td>
<td>333,000</td>
</tr>
<tr>
<td>Mortgage on Leasehold Improvements</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Leasehold Sale</td>
<td>600,000</td>
</tr>
<tr>
<td>Leaseback Equity Sale</td>
<td>200,000</td>
</tr>
<tr>
<td>Management Contract Sale</td>
<td>10,000</td>
</tr>
</tbody>
</table>

$2,543,000

At least one reason why the parts may be worth more than the whole is that the return after taxes is increased where maximum use of the lease is made. With the increasing acceptance and marketability of leases and leasehold interests, and with continuing tax advantage,

4. Based on an example used by Casey, W.J., op. cit., p. 21
this method of financing is not likely to disappear.

(E) **Sale and Leaseback Of Improved Property At A Price Less Than Either Cost Or Market Value.**

Almost every sale and leaseback transaction takes place at less than the market value of the property. The lessee-vendor, in addition to receiving cash, also receives the operational benefits, and if capital gains tax is involved, will have less penalty than if sold at market value. For example, a building originally costing $1,000,000 now has a book value for tax purposes of $800,000, a market value of $1,000,000, and a mortgage of $600,000. Mortgage payments amount to $72,000 annually, and tax deductions, including depreciation and interest, now amount to $70,000. The building is sold for $900,000 under a leaseback payable at $90,000 annually, with renewal options. The capital gain has been reduced from $200,000 on market value to $100,000 on the sale, on which tax would be paid. The increase in tax deductions would be $20,000 the first year, and, as compared to former tax deductions with the mortgage, increasing amounts in each successive year (the $90,000 deduction would remain constant). The lessee would have an additional $300,000 in cash for an increase in disbursements of $18,000 annually before taxes, or $8,000 after taxes (assuming a 50% tax bracket), reducing to a positive cash flow in a number of years. He would have continued use of the property, but
might lose the reversionary interest (not necessary in Canada), and would pay a tax on a capital gain of $100,000. This is probably a typical case where the ability to use land as a deductible expense is the source of a large portion of the benefit.

(F) Use of Long Term Leases by Supermarkets, Drug and Department Stores.

It is a pleasure to see a work of art, and some of these creations are not only ingenious, they are highly artistic. The manner in which large national and international chains, and well known department stores use their credit, and a knowledge of tax laws, to obtain new outlets with low interest rates, and low cash payments, might proceed as follows: purchase land and construct buildings according to desired specifications; use the credit rating to obtain a 90% or higher mortgage, at minimum rates of interest; sell and leaseback the land and buildings, subject to the mortgage. The sale will usually be to a person in a high tax bracket, for a low yield and low cash return, with a long initial term and renewal options, with possibly a rejectable offer to purchase in the United States, or a purchase option in Canada. The low yield and low cash return is obtained because of the very advantageous tax loss benefit available to an individual in a high tax bracket.

The following is an example of a transaction where a 100% loss benefit available to an individual in a high tax bracket.

mortgage was obtained by a well known chain offering a higher than normal interest rate. A mortgage of $2,800,000 was obtained for a property where the land cost $260,000 and the improvement $2,531,000. A leasehold interest in the property was then sold for $225,000 (clear cash over a 100% mortgage!) with the inducement that in 3 1/2 years there would be a cumulative tax loss of $375,619, plus a cash flow of $40,222 tax free. The entire investment would be more than recovered in this period. Over the ten year period during which the loss lasted, there would be a tax benefit (loss) of $653,393, and a cash return of $114,920, on an investment of $225,000.

This type of transaction most likely was largely instrumental in the formation of the announced intention, contained in the 1971 Canadian income tax budget proposals, to exclude depreciation from the loss incurred on real property when applied to other income. If so, the legislators are picking at the fringes, but not touching the heart of the problem. The use of the purchase option or rejectable offer to purchase is not common where the real estate, and not the lessee's name, is of major collateral importance. Examples of such Canadian ventures are Montreal's Boulevard Shopping Centre, and St. Laurent's Norgate Shopping Centre.

(G) The Use Of Long Term Leases In The Financing Of Service Stations.

Leases have been extensively used for the financing of service
stations, becoming pretty well standardized in the later fifties, the trend being towards longer leases. The typical lease was for an initial duration of ten to fifteen years, some up to twenty five years, with one or two options for periods of five years. Purchase or refusal options are common; as are clauses to protect the sub-lessee in event of condemnation, and public liability clauses to protect the owner from legal actions arising out of the lessee's use and occupancy. The sub-lessee often pays for increases in taxes over the first year, and all repairs other than to underground equipment, roof, and insurable repairs. Gallonage provisions are common; and 1¢ per gallon for ground leases, 1 1/2 for improved property, are typical provisions. From a taxation point of view, there are offsetting trends; the implementation of capital gains taxes should enhance the popularity of leasing, whereas the current high interest rate levels might decrease the importance of leases in long term investments. It appears that the larger oil companies put greater emphasis on purchasing because of the continued use of good locations over a long period of time, and the land appreciation factor. This will not affect the importance of leasing in Canada as much as it will in the United States, because of the purchase option benefit.

The Use Of Long Term Leases For Motels And Hotels.

Motels are considered high risk investments, where equity capital of half the total cost, or more, is often required. Well known franchise motels are increasingly expensive, with minimum investments of $250,000 and up. The owner is often not involved in the operation, and sub-leases the motel to a responsible lessee, with a large security deposit of $25,000 to $50,000 or more, for a period of 15 to 25 years or longer, with suitable renewal options. The tenant-operator pays rent, taxes, insurance and maintenance. The owner pays his mortgage, if any.

Chain hotels, such as the Sheraton and Hilton, make use of tax advantages offered by the long term lease. The procedure is essentially the same as that used by large supermarket chains, where the hotel is obtained for low annual cash payments, with favorable options, by offering high income investors large incentives in the form of tax losses. For example, the Sheraton Corporation of America purchased a 200 room hotel for $1,335,000, with $335,000 cash and a $1,000,000 mortgage, under a sale and leaseback. The lease was for 15 years, at $118,000 annually, with two 15 year renewal terms of $75,000 per year.

The exceptionally large depreciation and interest charges which the investor was able to claim resulted in a substantial tax loss for many years, which was applicable to his rental income. To enhance this tax advantage, the lessor could purchase the furniture, subject to fast write-off.

In terms of value, one of the largest long term leases was made by a syndicate, which purchased the Hotel Taft in New York City for $19,200,000. It then sold the hotel for $18,000,000 under a sale and leaseback, with a minimum annual rental of $1,950,000. The leasehold interest was valued at $1,200,000.

(I) Use Of The Long Term Lease For Office Buildings And Apartments.

Long term leases of property of this type became prevalent in the United States (and soon after in Canada), when state laws covering life insurance company investments were liberalized, allowing ownership of non-residential real estate properties.

Where the building is occupied by a tenant largely for his own use, it is the credit standing of the tenant, rather than the use of the building as collateral, which is of primary consideration. Where the building is made expressly for the purpose of subleasing, the value of the real estate is of first importance. With larger buildings, leasebacks

have been arranged separately for land and for buildings. The market
for the sale of riskier leasebacks on smaller buildings is not yet well
developed in Canada. Examples of Canadian transactions in this cate-
gory include Ottawa's Copeland Buildings, and Carlingwood Plaza, Ottawa.

(J) **Long Term Equipment Leases.**

Canadian business trends reflect those in the United States,
where the rapid growth of long term leasing is as yet unabated. Some­
what optimistically, a leading automobile manufacturer recently stated
that 50% of all automobiles would be leased within the next five years.
The tremendous potential is further indicated by the glowing hopes of
CNA Nuclear Leasing Incorporated, in the "highly promising" field
of leasing nuclear reactor cores to debt-heavy electric utilities. In
1969 there were 15 nuclear reactor plants in the United States; in 1970
proposed expenditures of $250,000,000 were estimated as required,
which would increase to $5,000,000,000 by 1980, representing 180
plants, with each "core" costing, at present values, $20,000,000 to
$35,000,000.

There are at least four areas in which the potential for long term

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10. Lancashire, K.E., "The 'Pros and Cons' of Lease Financing",
**New Concepts in Leasing**, The Canadian Institute of Chartered
leases could soon be measured in terms of thousands of millions; the auto and truck field, nuclear reactor cores, aircraft requirements, and the computer field. Any tax potential in even a small share of this market could produce hundreds of millions in government revenues.

Comparisons of leasing, borrowing and the use of equity capital for tax purposes involve many calculations, which are more subjective than similar calculations with longer term, higher value real estate. Usually, the cost of leasing is much higher than the cost of borrowing, or the cost of equity capital, before taxes. Surprisingly, the majority of firms who lease are well financed with unused bank credit; this would tend to give credence to the primary objective of tax advantage in most long term lease contracts. However, these firms may desire to extend their credit, preserve their working capital, use bank credit for current operations, or remove fixed assets from the balance sheet. Undercapitalized companies find leasing indispensable, and special circumstances, such as severe usage, multiple shift usage, technical obsolescence, and fear of non-compatibility may make it seem more attractive.

On the other hand, many of these deemed benefits are illusory. Working capital is not reduced when money is borrowed on security of assets purchased. Current accounting practice requires that important leases be mentioned in footnotes, if not on the face of the balance sheet,

and loaning institutions are fully aware of the availability and contingent liability of leases. Even though tax advantage may not be as pronounced when compared to realty leasing, it is still highly significant. There are many variations, but as a rough rule of thumb, tax advantage is maximized when equipment is leased for a period of over three years, but under ten years. When under three years, the extra cost of leasing may be greater than tax savings, particularly when terminal loss provisions apply. When over ten years, the size of capital cost allowance deductions with borrowed capital will more than offset lease deductions, when interest expense is added to depreciation. Table 1 (Page 54), would tend to support this conclusion; the present value of borrowing at the end of the first and tenth years is less than that of leasing.

Table I, from an article in the Canadian Chartered Accountant, is used to illustrate four points. This table was based on the following assumptions: Original cost of equipment, $10,000; interest on borrowed capital 7% per annum; capital cost allowance, 20% per annum; tax rate 52% per annum; present value after tax, 7% per annum; and lease rent $2,820 for the first five years, and $235 for the next five years.

It is not easy to compare the costs of leasing to those of borrowing, and to the use of equity capital. This table makes no allowance

### TABLE 1

**COMPARATIVE COSTS OF OWNING AND LEASING EQUIPMENT**

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal Payments</th>
<th>Finance Charges</th>
<th>Capital Cost</th>
<th>Tax Ded.</th>
<th>Tax Expenses</th>
<th>Tax Saving</th>
<th>Net Outlay</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>OWNING - USING BORROWED CAPITAL</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>2,000</td>
<td>700</td>
<td>2,000</td>
<td>2,700</td>
<td>1,404</td>
<td>1,296</td>
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for the value of equity (working) capital to the firm, thus overstating the value of leasing. However, evaluation of the worth of working capital is necessarily subjective, and this is probably the reason for omission. Thus, any calculation of comparisons must be to some degree arbitrary. In ten years, the present value of leasing, $5,880 is greater than that of borrowing, $5,423. This is to be expected. If equipment has a useful life of ten years or more, it might be better to purchase on the instalment plan, rather than to lease.

Table I indicates the high cost of leasing. The cash outlay after ten years for leasing is $15,275, for borrowing $12,100, and for use of equity capital $10,000. Even though the total cash outlay is $3,175 more than for borrowing, leasing gives such a large tax advantage that this amount is reduced to $457 ($5,880 - $5,423).

The final, and most interesting observation regarding this Table is made with the use of an assumption. Assume, for tax purposes, the lease will be treated as a purchase. There would then be a great change as compared to borrowing. The tax differential would be decreased by $2,207 ($7,940 - $5,733) over a ten year period, before present value discounting. There would be little incentive to pay the gross extra cost of $3,175 ($15,275 - $12,100). Most leasing would probably cease in similar circumstances; few non-tax advantages would overcome this differential, but who would suffer? The remarkable feature is that over a ten year period, the former lessee would save
$457 ($5,880 - $5,423), and the government would also benefit from a portion of the reduction in tax savings of $2,207. When it is considered that Table 1 does not account for the present value of future tax relief, or of terminal loss benefits for assets not leased, the timing of tax deductions, and not the savings, is the attraction from a taxation point of view.

What, then, would result if the government assumed such leases to be purchases? According to the last example, monetarily, both the government and taxpayer would benefit. Actually, the government would save comparatively little. Tax savings are based on the cost of equipment to the taxpayer, and over a ten year period, there is $3,175 less paid, when leasing is compared to borrowing. This case is not to be confused with that of long term leasing of land, where the government may effectively pay for up to half the cost of the land. However, although any viability on a non-tax nature given by leasing would disappear, a strain would be removed from the system of capital cost allowances, and a stimulus given to the business community by inducement for increased economic efficiency. The artificial support given to leasing companies would be removed by reduction of tax advantage. The effect would not be disastrous to these leasing companies. They are loaners of money, and borrowing would still be required.
CHAPTER 7

SECTIONS PERTAINING TO LONG TERM LEASES IN THE
CANADIAN INCOME TAX ACT.

The sections referred to in the chapter heading are stated in
the body of the thesis, and not in appendices. They are integral to
the topic discussed, and are intended for comparison with provisions
stated in Chapter 8, in order that conclusions may be drawn on the
merits or demerits of existing Canadian and American legislation.

The removal of Section 18 in 1963 did not mean that lessors
and lessees were free to take full advantage of purchases by use of
the lease. The removal meant that tax benefits accruing from normal
leases would probably be allowable, even with purchase options. Un-
reasonable benefits would continue to be disallowed. For instance, a
million dollar building could not be leased for two years, then purchased
for one dollar, and the lease payments be claimed as an expense. Sec-
tion 12(2) would apply. Sections pertaining to long term leases have been
grouped under four headings: those applicable to resident lessees, those
applicable to non-resident lessees, those applicable to lessors, and
those applicable to leasehold interests.

Sections Applicable To Resident Lessees.

Section 11(1)(y). Cancellation of leases.

"The following amounts may be deducted in computing the income
of a taxpayer for a taxation year: an amount that would not otherwise be deductible, paid by the taxpayer in the year to a person with whom he was dealing at arm's length for the cancellation of a lease of property of the taxpayer leased by him to the person."

Added in 1965, this subsection gives a further advantage to leasing over purchasing. The disposal costs of a purchased asset must be treated as reduction of capital cost, but similar leasing expenses are deductible. This subsection refers to a lessor, not to a lessee, but it is understood that the Revenue Department permits the deduction of lease cancellation payments by a lessee.

Section 12(1)(a).

"An outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer."

A leasehold property must be acquired for the purpose of earning income, to qualify for deductions. This subsection could eliminate the transfer of property, in whole or in part, the primary purpose of which is in contemplation of death, or which is a gift.

Section 12(2).

"In computing income, no deduction shall be made in respect of an outlay or expense otherwise deductible except to the extent that the outlay or expense was reasonable in the circumstance."
Disallowed is the unreasonable portion of an excessive rental, terminal loss, or other expense included in a lease. This section appears to be used to an increasing extent by the Department, with fair market value as a criterion. It does not exclude leases with purchase options, but would apply where payments were unduly accelerated, or where the purchase option was at significant variance with the market value.

Section 17(1). Inadequate Considerations.

"Where a taxpayer carrying on business in Canada has purchased anything from a person with whom he was not dealing at arm's length at a price in excess of the fair market value, the fair market value shall, for the purpose of computing the taxpayer's income from the business, be deemed to have been paid or to be payable therefor."

This applies to non-arm's length transactions where total lease payments for an asset are unreasonable.

Section 137(1). Artificial transactions.

"In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce the income."

Particularly applicable are non-arm's length lease transactions made primarily for tax benefit. Whereas Section 12(2) would disallow a
portion of an expense, this Section would disallow the entire expense.

Section 138(1)  
Tax Avoidance.

"Where the Treasury Board has decided that one of the main purposes for a transaction or transactions effected before or after the coming into force of this Act was improper avoidance or reduction of taxes that might otherwise have become payable under this Act, the Income War Tax Act, or the Excess Profits Tax Act, 1940, the Treasury Board may give such directions as it considers appropriate to counteract the avoidance or reduction."

This is a more powerful Section than 137(1), and would not be used unless it could be proved that some measure of fraud or deceit was involved.

Section 1101(5).  
Lease Option Agreements.

"Where, by virtue of an agreement, contract or arrangement entered into on or after May 31, 1954, a taxpayer is deemed by Section 18 of the Act to have acquired a property, a separate class is hereby prescribed for each such property, and if the taxpayer subsequently actually acquires the property, it shall be included in the same class."

This is a transition period provision assigning separate classes.

Section 1102(1)(i)  

"......that was deemed by Section 18 of the Act as enacted by subsection (l) of Section 8 of Chapter 32 of the Statutes of Canada, 1958,
to have been acquired by the taxpayer and that did not vest in the taxpayer before the 1963 taxation year."

This was also a transition provision, repealed in January, 1966.

Sections Applicable to Non-Resident Lessees.

Section 17(3). Inadequate Considerations.

"Where a taxpayer carrying on business in Canada has paid or agreed to pay, to a non-resident person with whom he was not dealing at arm's length... an amount greater than the amount... that would have been reasonable... that reasonable amount... shall be deemed to have been the amount that was paid or is payable...

The degree to which a transaction is "reasonable" is first determined by a tax assessor, and finally, if disputed, by a judge. The section could apply to a lessee or to a lessor.

Section 17(4). Inadequate Considerations.

"Where a non-resident person has paid, or agreed to pay, to a taxpayer carrying on business in Canada with whom he was not dealing at arm's length... an amount less than the amount that would have been reasonable... the reasonable amount shall... be deemed to have been the amount that was paid or is payable..."

This section could also apply either to a lessee or to a lessor.
Section 106(l)(d). Non Resident Tax.

"Every non-resident person shall pay an income tax of 15% on every amount that a person resident in Canada pays or credits, or is deemed by Part I to pay or credit, to him as, on account of, in lieu of payment of, or in satisfaction of rent, royalty or a similar payment...."

The 15% withholding tax refers to gross, not net rents. Payment of property taxes by the tenant has been held to be payment similar to rent, and therefore subject to withholding tax. Under a net lease, major repairs, property taxes, and other landlord expenses would be added for the 15% deduction.

Section 110. Alternative re rents and timber royalties.

"Where an amount has been paid during a taxation year to a non-resident person as, on account of, or in lieu of payment of, or in satisfaction of, rent on real property in Canada or a timber royalty, he may, within two years from the end of the taxation year, file a return of income under Part I...."

With real property, the non-resident lessor may elect to file a Canadian tax return, and pay tax on the rental income as if he were resident in Canada, and his interest in real property in Canada were his

only source of income. No deductions are allowed under Division C, (Personal Exemptions), and credit for the 15% tax is taken. A refund can be obtained for excess payments. The non-resident must file a Canadian tax return in the year of recapture if he had previously filed a return under Section 110, and claimed capital cost allowances. The effect of this undertaking is that the withholding tax is reduced from 15% of gross rents to 15% of net rents, or rental profits. It is customary to file this undertaking when a lower tax would be payable.

Sections Applicable to a Lessor.

Section 17(2). Inadequate Considerations.

"Where a taxpayer carrying on business in Canada has sold anything to a person with whom he was not dealing at arm's length at a price less than the fair market value, the fair market value thereof shall, for the purpose of computing the taxpayer's income from the business, be deemed to have been received or to be receivable therefor."

This Section would apply where the lessor sold formerly leased assets to the lessee, or to another person, at less than, or more than fair market value, in a non-arm's length transaction.

Section 20(1). Excess of Proceeds Over Undepreciated Capital Cost.

"Where depreciable property of a taxpayer of a prescribed class has, in a taxation year, been disposed of and the proceeds of disposition exceed the undepreciated capital cost to him of depreciable property of
that class immediately before the disposition, the lesser of (a) the amount of the excess, or (b) the amount that the excess would be if the property had been disposed of for the capital cost thereof to the taxpayer, shall be included in computing his income for the year."

When the lessor disposes of the property, this Section prescribes the credit to his income and to the capital cost allowance class, of proceeds of disposition.

Section 1100(2)(b). Allowances In Respect Of Capital Cost.

"Where all or a major portion of the property of a prescribed class that was not disposed of by a taxpayer prior to January 1, 1968, is disposed of and, on or after its disposition, it is acquired by a person or persons with whom the taxpayer did no deal at arm's length....... deductions allowed....... shall....... not exceed the deductions....... if the proceeds of disposition....... had equalled the fair market value."

This means that the terminal loss available to a lessor dealing indirectly at non-arm's length must not be greater than if the property had been disposed of at fair market value.

Sections Applicable To Leasehold Interests.


"Property that is a leasehold interest except (a) an interest in minerals, petroleum, natural gas, other related hydro-carbons or
timber and property relating thereto or in respect of a right to explore for, drill for, take or remove minerals, petroleum, natural gas, other related hydrocarbons or timber, (b) that part of the leasehold interest that is included in another class by reason of subsection (5) of section 1102, and (c) a property that is included in class 23."

This section defines the limits of a leasehold interest class.

Schedule H. Leasehold Interests.

"(1) For the purpose of paragraph (b) of subsection (1) of section 1100, the amount that may be deducted in computing the income of a taxpayer for a taxation year in respect of the capital cost of property of Class 13 in Schedule B is the lesser of

(a) the aggregate of each amount that is a pro-rated portion of the part of the capital cost to him; or

(b) the undepreciated capital cost to the taxpayer as at the end of the taxation year.

(2) the pro-rated portion for the year is the lesser of

(a) one-fifth of that part of the capital cost; or

(b) the amount determined by dividing that part of the capital cost by the number of twelve month periods (not exceeding forty such periods)."

Subsection (3) is omitted from the above. It states that the
capital cost allowance for a leasehold is not greater than 20% of the capital cost, and not less than 1/40th of the capital cost, unless the remaining balance to be depreciated is less than 1/40th of the capital cost.

Section 1100(1)(b).

Leasehold Interest.

"...there is hereby allowed to a taxpayer...... a deduction for each taxation year equal to such amount, not exceeding the amount for the year calculated in accordance with Schedule H, as he may claim in respect of the capital cost to him of property of Class 13 in Schedule B"

Allowances for leasehold interests are authorized in this section.

Section 1102(4).

Improvements or Alteration to Leased Properties.

"For the purpose of paragraph (b) of subsection (1) of Section 1100, capital cost includes an amount expended on an improvement or alteration to a leased property, other than an amount expended on (a) the construction of a building or other structure, (b) an addition to a building or other structure, or (c) alterations to buildings which substantially change the nature or character of the leased property."

Certain buildings and additions will hereby not be allowed depreciation as Class 13 assets. They may be depreciated in the normal way. Thus, with an arm's length sale and leaseback, in order to qualify for improvements under Class 13, it is necessary to complete construction, additions, or substantial improvement before the lease is effected.
Section 1102(5)  Improvements or Alterations to Leased Properties.

"Where the taxpayer has a leasehold interest in a property, a reference in Schedule B to a property that is a building or other structure shall be deemed to include a reference to that part of the leasehold interest acquired by reason of the fact that the taxpayer has (a) erected a building or structure on leased land, (b) made an alteration to a leased building or structure, or (c) made alterations to a leased property unless the property is included in Class 23 in Schedule B."

This subsection should be read concurrently with subsection 1102(4). The same comments apply.

Section 1102(6)  Leasehold Interest Acquired Before 1949.

"For the purpose of subparagraphs (i) and (ii) of paragraph (b) of subsection (1) of Section 1100, where an item of capital cost has been incurred before the commencement of the taxpayer's 1949 taxation year, there shall be added to the capital cost of each item."

This 1949 transitional provision is still retained.
CHAPTER 8.

RULINGS AND REGULATIONS PERTAINING TO LONG TERM LEASES
IN THE UNITED STATES.

Sections relating to taxation of leases in "Treasury Regulations" have been constantly amended by various Acts, such as the Tax Reform Act of 1969, and the Revenue Acts of 1962 and 1964, and by various bills, such as the Technical Amendments Bill of 1958. These Regulations are "interpreted" by the Internal Revenue Service in more or less formal publications called "Revenue Rulings". The more important applicable Regulations will be indicated in numerical order, after which the more important applicable revenue rulings will be given.

Whereas Canadian authorities, since 1963, have made a few minor, but no important changes in the taxation of leases, authorities in the United States appear to have adopted the opposite attitude, and have made taxation of long term leases more rigorous. The Technical Amendments Bill of 1958 sought to remedy the inequity where leasehold improvements made by an owner were required to be deducted over the life of the improvements, but a lessee could deduct them over the remaining life of the lease. The Bill stated that the term of the lease was

to include renewal periods where the lease, excluding renewal periods, was less than 60% of the useful life of the improvement; or the cost of acquiring the lease was less than 75% of the cost attributable to the remaining term of the lease. The Revenue Acts of 1962 and 1964 complicated the leasing decision by reducing the desirability of leases where they were affected by investment credit allowances, depreciation recapture, and imputed interest. The Tax Reform Act of 1969 provided for the imposition of a minimum tax on tax preference income, including that commonly encountered in equipment leasing, such as amortization of railroad rolling stock; capital gains, and accelerated depreciation of real property.

Regulations:

1.61 - 8(b)  Advance rents and bonuses paid by the lessee to the lessor upon the execution of a lease are income to the lessor, reportable in the year when received, regardless of the period covered or the method of accounting used by the lessor.

It would appear that in Canada the lessor may defer such payments.

1.62 - (3)(a)  A deduction for rent is allowed only if the property under lease is one "to which the taxpayer has not taken or is not taking title or in which he has no equity."

This distinguishes a purchase from a lease in that it guards against equity accumulation, and could nullify the tax advantage of a
lease with a purchase option, or where total rents were in excess of fair rental value, or the option price was below market value, or where substantial improvements were required by the lessee, or where payment of interest was indicated.

1.62 - 11(b)(1) This provides for amortization of an improvement over the life of the lease, if the asset life is in excess of the lease period.

For example, if a building with a 40 year life is constructed on land leased for 25 years, the building may be depreciated over 25 years. The cost of improvements may be written off over the term of the lease, including all renewals, if the remaining portion of the original term of the lease is less than 60% of the estimated useful life of the improvement. Where the lessor and lessee are related, then the period of the lease will be disregarded and the useful life of the property will be the sole consideration.

1.72 - (b)(1)(b) This section allows a sale and leaseback in order to preserve a loss carryover that is about to expire because of the five year limitation on carryovers. To be allowed, the transaction must approximate fair market value.

Thus, a sale and leaseback at a gain may be worth effectuating solely for tax reasons. The effect of the transaction will be to establish a higher income, salvage the carryover, and preserve deductions for later years.

1.78 If the value of the first term of the lease is more than 75% of
the value of the entire lease, the first term only may be used for amortization purposes, unless it is reasonably certain the lease would be renewed.

Provision is made for the determination of the period during which leasehold costs may be amortized where there are options to renew. However, only the cost of a leasehold is considered. This might not apply where there was a substituted base, as under Regulation 1031(d).

267. Where the lease is a result of a sale to related parties, that portion deemed to be a loss on the sale may not be deductible.

This is similar to non-arm’s-length provisions in the Canadian Act.

337. Where a corporation adopts a plan of liquidation, completes the liquidation process within one year thereafter, and sells property during that one-year period, no taxable gain or deductible loss will be recognized on that transaction.

This is a liquidation measure for which there appears to be no Canadian counterpart.

453. The profit on a sale that is reported in any year is that proportion of the payments actually received in that year which the gross profit on the sale bears to the total contract price.

A seller is hereby provided with an alternative of reporting all his gain in one year or spreading the gain over several years via the instalment method. Although not generally known, the same treatment
is accorded under the Canadian Income Tax Act, under Section 85B, a section which is not obvious, but is so interpreted by the tax authorities. This interpretation was confirmed directly with the chief assessor, Winnipeg.

483(c). Where property is sold on an instalment basis and part of, or all of the payments are due more than one year after the sale date, a portion of each payment will be treated as interest if the agreement provides no interest, or too low an interest rate.

Added in 1964, this regulation precludes the lessor and lessee from gaining tax advantage by distinguishing the interest factor. At about the time legislation was being enforced in the United States, it was being dropped in Canada.

493 - (2)(a)(2) A sale is disqualified for instalment reporting where the initial payment exceeds the 30% limitation.

There is no such legislation in Canada.

1031(a)(1)(c) No gain or loss shall be recognized where the taxpayer exchanges property used in trade or business for property of a like kind for the same use. For this purpose, a leasehold with 30 years or more to run, and real estate, are property of like kind.

Regulations 1031(a) and (b) apply where gain on a sale will be capital gain and loss will be deductible as an ordinary loss, provided the sale is for fair market value to an unrelated party.
Where the leaseback is for more than thirty years, the extra element of taxable gain would be limited to the lower of the leasehold value or the cash sales price or consideration other than the leasehold value.

This provision refers to exchanges of like kind property referred to in regulation 1031(a). Since the lease is for more than thirty years, the sale and leaseback would constitute a like kind non-taxable exchange. Where under thirty years, the amount of the unexpected capital gains tax would fall upon the full amount of the added gain arising from the value assigned to the leasehold. There is no tax legislation for like kind property in Canada. To show the effect of this legislation, the following example is used.

X Company owns realty with a book value of $50,000, and a fair market value of $100,000. It wishes to sell and leaseback for 31 years. Sale at $100,000 will give a capital gain of $50,000, with annual payments of $8,000, whereas sale at $50,000 will reduce annual payments to $4,000. The leasehold value is $60,000. Under Regulation 1031(b), sale at $50,000, with leaseback will give a capital gain of $60,000 ($50,000 cash plus $10,000 leasehold value). However, only $50,000 of that $60,000 will be taxed, giving the same capital gain as if sold for $100,000. X Company would be given an inducement to
pay the capital gains tax in return for future tax and cash benefits.

1231. This is a lengthy regulation, regarding the sale of real or depreciable property used by a corporation in its trade or business, determining the tax treatment of the gain or loss, whereby gains are normally treated as capital gains, and losses are deductible from ordinary income.

Involved is often the decision or choice between present value of a tax payable now as compared to that of annual increased deductions if money is borrowed.

Revenue Rulings.

55 - 540 (4, 01) Whether an agreement is in substance a lease or conditional sale depends upon the intent of the parties as evidenced by the provisions of the agreement, read in the light of the facts and circumstances existing at the time the agreement was executed. The fact that the agreement makes no provision for the transfer of title, or specifically precludes the transfer of title does not, of itself, prevent the contract from being held to be a sale of an equitable interest in the property.

Leases will be interpreted as purchases and sales if one or more of the following conditions are present:

A. Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee.
B. The lessee will acquire title upon the payment of a stated amount of "rentals" which under the contract he is required to make.

C. The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title.

D. The agreed "rentals" materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property.

E. The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made.

F. Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.

55 - 540 (4.02) A lessor can sell the property to the lessee without granting the lessee an option to purchase, by simply entering into a lease for a term which equals or exceeds the useful life of the property. The existence of the option of purchase in a lease is basically irrelevant.
Where a purchase option bears a resemblance to the price at which the property could be bought now plus carrying charges and rental payments, then the transaction is probably a conditional sale. Where the chances that the option will be exercised are very high, it is probably a conditional sales contract.

Where the sum of the specified rentals paid over a relatively short part of the expected useful life of the equipment approximates the price at which the equipment could have been acquired by purchase at the outset of the agreement, plus interest, and the lessee may continue to use the equipment for an additional period for relatively nominal payments, it may be assumed that the parties have entered into a sales agreement. Where rentals are quoted in hourly, daily or weekly amounts, and if the option to purchase is expressed in terms of equipment value at the time the option is to be exercised, there is an indication of original intent to lease.

Revenue ruling 55.540 states the basic rules by which a lease is distinguished from a purchase. These rules include intent, fact, equity accumulation, fair market value, and useful life of the asset. The ruling was introduced eight years before Section 18 of the Canadian Income Tax Act was scrapped, and specifically mentioned that the purchase option might be basically irrelevant (Regulation 55 - 540 (4.02). Equity accumulation appears to be the Internal Revenue Service key to
the question "Is this transaction one of rental or purchase?"

60-4 (C.B. 303) A leasehold which, at the time of its sale has thirty or more years to run, constitutes real property. Where a taxpayer, not a dealer in such property, used the leasehold in his trade or business and held in excess of six months, any gain or loss upon sale must be considered together with other capital assets, and their gains and losses. Where gains exceed losses, they shall be considered as from the sale or exchange of capital assets held for more than six months. otherwise, they shall not be considered as gains and losses from the sale or exchange of capital assets.

This ruling was intended to clarify the status of long term realty leases.

60-22 (C.B. 56) Where initial security deposits were too high, they were to be apportioned over the life of the lease, including renewal options.

Yet another loop hole was covered by this regulatory ruling.

61-217 Where a long term lessee erected at his cost a commercial building on land leased to him and the assigned his entire interest in the improved realty to a third party, who later assigned his remaining interest to a fourth party, and so on, the capital investment of each assignee in such interest is recoverable through allowances for depreciation or amortization, but only to the extent appropriate during the period
he owns it.

This provision, and the one below, was made to cover a specific case.

68 - 432. A sale and leaseback of mineral properties between a parent corporation and its dormant wholly-owned subsidiary is to be disregarded for tax purposes, since it is without economic substance.
CHAPTER 9.

CANADIAN TAX CASES RELATING TO LONG TERM LEASES.

It is difficult to overestimate the influence of tax cases. Dominion Tax Cases¹ (DTC's) are widely read by accountants, lawyers, businessmen, assessors and legislators. According to decisions based on individual cases, either legislation must be introduced to counteract unfavorable decisions, or legal, accounting and business practice must adapt, where the status quo is altered. Probably the most influential tax case with respect to lease-purchase options in Canada was the Harris case²; which involved an attempt to claim extreme, even outrageous tax benefits based on obviously poorly worded legislation, and surprisingly carried to the Supreme Court of Canada. The points of similarity between Canadian and American tax cases are relatively few with respect to taxation of long term leases. This is the result of differing legislation. American legislation is based upon concepts which are much more comprehensive than that, or the lack of it, in Canada. Their legislation is far more encompassing than was former Section 18 of the Canadian Income Tax Act. The fact that they do tax many long term leases as purchases, whereas the lack of similar taxation in Canada has been held by the Carter Commission³ to threaten our capital cost allowance system, would appear to make their system of
taxation of long term leases, in spite of its many faults, much superior to the inexcusable and inequitable situation now found in Canada.


What appeared to be a loophole was magnified to ridiculous lengths in a transaction which no court would have allowed, but where the wording of Section 18(1) appeared to be unambiguous in its leniency.

A service station was purchased for $31,000, and leased at an annual rental of $3,900 for 25 years, by a company which in turn gave a sublease for 200 years, with an option to purchase after 200 years for $19,500, and with an annual rent of $3,100. It was agreed that the sublessee was to receive, net, each year, the difference in annual rentals of $800. A capital cost of over $600,000 was claimed (200 x $3,100 plus $19,500), and allowances of over $30,000 were claimed in the first year. So confident was the originator of this scheme, Douglas Leaseholds Ltd., that the firm had used it twenty five times.

The judge found that it violated the rule of perpetuities, the term was frivolous, the property had not been acquired to earn income, but rather a tax deduction, that "payable" and "paid" were to be


distinguished with respect to rent, and finally the whole arrangement was artificial and fictitious. Nevertheless, the case was appealed to the Supreme Court of Canada (66 D.T.C. 5189), which also determined that the final option price was the purchase price on which allowances should be calculated. As a matter of interest, the lease with an option to purchase after 200 years was subordinate to, and concurrent with the lease to an oil company for $3,900 per year.


The lessee had a lease, with a purchase option exercisable at any time before the termination of the lease. The purchase price was $75,000, with a cash payment of $15,000 and a mortgage of $60,000. Part of the rent paid was to apply on the purchase price. It was argued that this was not a lease purchase because there were a plurality of conditions, not just one. The case was dismissed, because the singular includes the plural under the Interpretation Act.


Under a contract called a "Lease with Promise of Sale", annual instalments were $28,000, with interest on unpaid instalments and the right to purchase for $1.00. The Minister treated the annual payments

to the lessor as rent. The judge allowed the appeal - the intent was clearly to sell.


The court once more relied upon intent and the form of the contract. The appellant was prohibited from selling his property by the mortgagee, therefore a lease purchase option was drawn, with a one year rental of $10,000, and an option to purchase for $85,000 in one year, the $10,000 to be applied on the purchase price. The lessees were to pay the taxes and insurance. Although the option was not exercised, the Court ruled that this was intended to be a sale, and the $10,000 in the hands of the lessor was not income. The position of the lessees remained unchanged.


A lease with payments of $600 monthly, and a purchase option for $75,000, whereby $150 of the $600 was to apply on the purchase price if the lease was exercised was taxed as a rental payment of $600. The lessor contended it should have been $450, and the $150 was capital. The lease option was exercised. The appeal was allowed, Section 18(1) cited.

These were cases where attempts were made by the lessees to capitalize leases of one hundred and ninety nine years respectively. They were disallowed, and only rentals paid and the final option price were allowed for tax deduction purposes.


This case is applicable to the lessor, and not the lessee, but is pertinent to the subject of long term leases. The lessee exercised his option to purchase, whereupon the lessor requested that prior rentals received be deemed to be capital payments. This request was denied, and the appeal was refused. It was established law that the purchase is recognized only when the option is exercised, and prior payments are not retroactively affected.

It is understood that there were an amazing number of cases pending, awaiting the Supreme Court decision of the Harris case. If this had been favorable to Harris, much inequity would have been involved. Two conclusions are drawn from these cases. First, much reliance appeared to be placed on intent, and second, where tax laws were ambiguous, or resulted in inequity, the judges would attempt, with the means in their power, to uphold equity.
CHAPTER 10

AMERICAN TAX CASES RELATING TO LONG TERM LEASES

The experience and wisdom gleaned from American laws and tax cases can be well used by Canadian legislators. The British North America Act was written only after careful study of American constitutional experience, and was deemed to be an improvement on their system. Canadian and American criminal and civil laws find their derivation in the same source. Tax laws are based upon the same principles, and for the most part are very similar. The writer is of the opinion that if more study was made of American and other taxation methods, our taxation laws could be vastly improved, particularly with respect to the long term lease. In 1955 the United States Revenue Service published a Revenue Ruling saying "The existence of the option of purchase in a lease is basically irrelevant." It took Canada eight further years to find that the purchase option could not work as a basis for lease taxation, and in 1967, the Carter Commission appears to have based suggested taxation improvements on the purchase option. Why? It seems to be current folly that the study of other systems is not necessary because they are not relevant to our situation. They are relevant, very relevant.

There has been continued clarification, but relatively little change in thirty years in the attitude of American Courts towards capitalization of leases, in spite of the burgeoning importance of the long term lease. This is in direct contrast to the Canadian situation. As is to be expected, there are many cases on the subject, and more important examples will be mentioned by type of transaction.

_Sale at a Loss._

In the Century Electric case, the court determined that a lease of thirty or more years in duration, including renewal periods, would not be eligible for deduction of a tax loss. The taxpayer sold its foundry for a loss of almost $400,000, with a 95 year leaseback, subject to termination by the lessee at ten year intervals, commencing in twenty five years. The court ruled that there was a tax free exchange of like properties. Prior to this case, it was generally assumed that the thirty year rule applied only to different properties. The loss was permitted to be capitalized, and written off over the period of the lease. However, in the Jordan Marsh case, the Court of Appeals

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reversed a tax court decision which had attempted to follow the Century Electric treatment of like kind properties. In the latter case, the sale was at fair market value, for cash, and with a leaseback at fair market value. It was distinguished from the Century Electric Case in that fair market value was established. Properties were sold at a loss of $2,500,000, saving under the excess profits tax of that year about $2,000,000 in tax. The leaseback was for thirty years and three days, with a renewal option for another thirty years if new improvements were erected.

Where the leaseback sale was made at a loss, it would appear that the loss would be deductible in full now, and that annual deductions for lease rentals in the future would be smaller than the depreciation deductions that would have been taken. The internal revenue service have indicated that they will not follow the Jordan Marsh decision. The conflicting court decisions would indicate uncertainty on this point. Also, where the selling price does not correspond to the fair market value, the tax authorities could contend, as in the Century Electric case, that any loss sustained should be treated as a gift.

Option to Purchase Considered a Loan.

Cases where the lease with a purchase option were disallowed

5. Revenue Ruling 60 - 43, Internal Revenue Board, pp. 5 and 39.
and treated as a loan include Helvering v. F. & R. Lazarus & Co., and Merket, Inc., a packing plant with an appraised value of $3,800,000, and a book value of $1,600,000, for taxation purposes. This was sold for $1,000,000 and leased back for 21 years. The tax loss claimed would have wiped out current income. However, in a turnabout case, the taxpayer claimed that a repurchase option caused a sale and leaseback transaction to result in a loan rather than a true sale, and exercise of the option and resale resulted in a long term rather than a short term capital gain. This was rejected by the court because the original transaction involved a repurchase option at a price higher than the original sale price. The initial sale was ruled to be a true transfer. In each case, the claims appear to have been unreasonable. Where the transaction is primarily to escape taxation, the court will usually uphold disallowance, which is treated by the authorities as a loan, a gift, or a sale.

**Equity Accumulation.**

The cases of Fishing Tackle Products and Quartzite Stone Co., have indicated that a long term lease, whereby equity is accumulated in the asset leased, will be considered to be a purchase. That

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portion of the rents considered equity accumulation were disallowed, but in many instances, the entire transaction will be treated as a sale, as in the case of Truman Bowen.

**Economic Effect.**

In Chicago Stoker, the reasoning was that where there is an equity accumulation caused by rental payments exceeding annual depreciation, and total payments exceeding the value of the property, it is less a distortion of income to consider this a purchase than to offset the entire payment against the income of one year. The cases of Truman Bowen and Judson Milbs have similar reasoning.

**Business Intent.**

The principle of intent was set forth in the often quoted case of H. T. Benton, in which the Circuit Court said "Whether what is in

form a lease is in effect a conditional sales contract depends on the intention of the parties. If the parties in good faith actually intended to enter into a lease contract, then the taxpayer, up until the time that he exercised his option to purchase, acquired no title to or equity in the property." As long ago as 1876, the U.S. Supreme Court stated that it would look to the purpose, and not the name of a contract in the form of a lease. The courts have, without exception, adopted the all-or-nothing approach. They refuse to admit that payments may be serving both a function of leasing and of purchasing.

Non-arms length Leasebacks of Property to a Family Trust.

This is an interesting type of transaction, which should take place with more frequency in Canada, with the advent of the capital gains tax. The effect of this transaction is to freeze the value of assets transferred, and also to obtain an increase in tax deductions via greater rental payments, for business assets. Where the amounts of the rentals are reasonable and the taxpayer retains no reversionary interest, the courts have generally allowed deductions of rentals under Regulation 162(a)(3). The independence of the trustee and lack of a remainder interest in the grantor are important considerations.

In the Brooks case, deduction of rent under the lease was

allowed. The taxpayer irrevocably divested himself of the ownership of the property, and the gift and leaseback arrangement had economic reality. In the case of I. K. Furman, the transaction was said to lack economic reality. Economic reality, however, was achieved in an estate case, where the lessor, in a non-sale (gift) and leaseback transaction contended that a transfer of real property pursuant to a fifty year lease, with option to purchase after twenty five years constituted a conditional sale for tax purposes. The Court held that the transaction was a lease, not a sale, on the basis of the intention of the parties. The principle to be used in distinguishing between a sale and a lease is that where the lessee, as a result of the rental payments, acquires something of value in relation to the over-all transaction, other than mere use of the property, he is building an equity, and may be regarded as a purchaser. It is obvious that "property rights" as such were not considered in this judgment. They were in the case of K. R. Martin, a non-sale and leaseback, where the transaction was held to constitute an installment sale contract, the "accoutrements of ownership" being transferred

with the lease, and where the total amount of rental payments over
the lease period equalled the sale price, with all prior rental pay­
ments applying to the sale price at the time of exercise of the option.

Economic Substance or Reality.

The courts have held that a leaseback following the sale of
property is, alone, insufficient to invalidate the sale as lacking in
18 economic substance, as in the Standard Envelope and May Depart­
19 ment Store cases. There appear to be no Canadian tax cases on
this point, but since the practice of sale and leaseback has been in­
creasing, there seems little doubt that a similar ruling would apply.

Contribution of Property.

It was held, in the case of General Shoe Corporation, 20 that
a realized gain was made upon a contribution of appreciated property
to an exempt employees 1 trust, even though no payments were ex­
pected or required. The taxpayer was held to have realized the value
of the property upon transfer, presumably in the form of additional
employee incentive. However, in the case of the Colorado National
Bank of Denver, 21 the court held that a contribution and leaseback,

p. 41.


coupled with an option to purchase at a bargain price, constituted a deductible transfer to the employees' trust.

**Useful Life of Property.**

The concept of "property rights" appears to be recognized in the case of Midwest Metal Stamping Company, where the ruling was that a lessor can effectively sell the property to the lessee without granting the lessee an option to purchase, by simply entering into a lease for a term which equals or exceeds the useful life of the property.

It has been held that there are insufficient grounds for holding that a lease is a conditional sale contract where the lessee only "has some future hope of acquiring title." This ruling, however, does not obviate the very valid premise of useful life, and it unfortunate that former Canadian legislation did not recognize this point, at least as a criterion.

**Interest**

The Judson Mills case, as referred to, indicated what is now an established criterion. Where part of the payment under a lease is designated as interest or is readily recognizable as the equivalent of interest, this is further evidence that a sale was intended.

By far the most influential Canadian body in determining accounting procedures, auditing procedures, and statement presentation is the Canadian Institute of Chartered Accountants. The Institute's Accounting and Auditing Research Committee is at present "studying the problem of how long term leases should be accounted for and reported in financial statements."\(^1\) In 1957, the Research Committee issued Bulletin No. 14, which recommended that particulars of significant long term leases, unless apparent in the financial statements, should be shown in a note to the financial statements. This recommendation was confirmed in 1964 by Bulletin No. 20, and these findings have been incorporated into the "CICA Handbook".\(^2\)

The recommendation now appears to be inadequate: Gertrude Mulcahy, Director of Research, has said that "The question now facing the Committee is whether this type of disclosure is, in fact, adequate or whether the existing recommendations should be revised to require that property rights and related contractual obligations under lease

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2. CICA Handbook, The Canadian Institute of Chartered Accountants, Toronto, 1968, Sections 3060.05 and 3280.02.
agreements be recorded in the accounts and shown in the balance sheet."³

It is remarkable to note the continuing change in opinion since 1967 (just four years ago!), when it was reported that "in spite of the Committee's recommendations, disclosure of details by way of notes to financial statements has not received outstandingly widespread acceptance among Canadian business."⁴ There has since been a substantial increase in the proportion of companies setting forth details of long term lease obligations, as indicated by Table 2. Of the 325 companies studied over a period of time, the percentage showing details to all those indicating long term leases has steadily increased from 72% in 1965 to 87% in 1968. Moreover, the number of companies referring to long term leases has increased from 106 in 1965 to 124 in 1968. Table 3 shows the increase in the amount and type of information regarding long term leases shown in balance sheets. Table 4 analyzes the results of the writer's examination of 135 random annual reports of commercial and industrial companies for the years 1969 and 1970. The sampling for the year 1969 is deemed to be significant, and would indicate that long term leasing is more prevalent in the United States than

⁴. Ibid., p. 205.
in Canada, and that by 1971, the trend would be such that most major companies in Canada would make use of the long term lease.

The growing acceptance of the requirement to show details and make reference to long term leases on statements is indicative of two trends; first the increasing number and importance of long term leases, and second, a change in the former opinion, held by auditors, that long term leases, as executory contracts, need not be mentioned on the balance sheet. This change has taken place in spite of pressures for non-disclosure by the corporations concerned. One reason for the change may be the very real danger of malpractice suits. Bankruptcy due in part or in whole to over-extension of credit by long term leases may subject auditors to criticism, even legal and ethical blame, if no mention was made of these leases on annual statements.

The Research Committee of the Canadian Institute certainly does not appear to hold the belief that most long term leases are of an executory nature. On the basis of preliminary discussions, the committee concluded that "as a general rule, the inclusion of leased property rights as assets and the related obligation as liabilities in the balance sheet provides a fairer presentation of the resources held for use within the business and of its financial commitments than is achieved by note disclosures." This forward looking opinion will take some time to be

TABLE 2

LONG TERM LEASES SHOWN IN CANADIAN ANNUAL REPORTS

<table>
<thead>
<tr>
<th>Number of Companies</th>
<th>1968</th>
<th>1967</th>
<th>1966</th>
<th>1965</th>
</tr>
</thead>
<tbody>
<tr>
<td>Details of leases set out</td>
<td>108</td>
<td>94</td>
<td>82</td>
<td>76</td>
</tr>
<tr>
<td>Leases referred to or implied, but no details</td>
<td>16</td>
<td>17</td>
<td>22</td>
<td>30</td>
</tr>
<tr>
<td>Total reference to long term leases</td>
<td>124</td>
<td>111</td>
<td>104</td>
<td>106</td>
</tr>
<tr>
<td>No reference to long term leases</td>
<td>201</td>
<td>214</td>
<td>221</td>
<td>219</td>
</tr>
<tr>
<td>Total</td>
<td>325</td>
<td>325</td>
<td>325</td>
<td>325</td>
</tr>
</tbody>
</table>

Percentage of Companies showing details to all those indicating long term leases: 87% 85% 79% 72%

TABLE 3

NUMBER OF OCCURRENCES OF VARIOUS TYPES OF INFORMATION PROVIDED IN REPORTS

<table>
<thead>
<tr>
<th></th>
<th>1968</th>
<th>1967</th>
<th>1966</th>
<th>1965</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of minimum annual rental</td>
<td>92</td>
<td>81</td>
<td>73</td>
<td>58</td>
</tr>
<tr>
<td>Type of property leased</td>
<td>74</td>
<td>68</td>
<td>47</td>
<td>45</td>
</tr>
<tr>
<td>Maturity date or dates</td>
<td>555</td>
<td>49</td>
<td>39</td>
<td>327</td>
</tr>
<tr>
<td>Amount of aggregate rental</td>
<td>28</td>
<td>27</td>
<td>21</td>
<td>20</td>
</tr>
<tr>
<td>Term of lease</td>
<td>25</td>
<td>24</td>
<td>20</td>
<td>19</td>
</tr>
<tr>
<td>Renewal clauses or options at maturity</td>
<td>11</td>
<td>12</td>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td>Number of leases</td>
<td>8</td>
<td>9</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Existence of special features</td>
<td>8</td>
<td>7</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Principal details of sale and leaseback transactions in year in which transaction is effected</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>2</td>
</tr>
</tbody>
</table>


7. Ibid., p. 71.
LONG TERM LEASES SHOWN IN CANADIAN AND AMERICAN
ANNUAL REPORTS, AS SHOWN BY A RANDOM SELECTION
OF 135 CORPORATIONS

<table>
<thead>
<tr>
<th>Number of Companies</th>
<th>1969</th>
<th>1970</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Canadian Annual Reports:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reference to long-term leases</td>
<td>18</td>
<td>6</td>
</tr>
<tr>
<td>No reference to long-term leases</td>
<td>24</td>
<td>2</td>
</tr>
<tr>
<td><strong>American Annual Reports:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reference to long-term leases</td>
<td>50</td>
<td>3</td>
</tr>
<tr>
<td>No reference to long-term leases</td>
<td>32</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>124</strong></td>
<td><strong>11</strong></td>
</tr>
</tbody>
</table>

accepted. One year after it was published, a contradictory finding was printed in the same publication, "disclosure by way of a note to the financial statements of the pertinent details of leaseback and sale and leaseback transactions is appropriate treatment in most circumstances."

While it is not the purpose of this thesis to discuss preferred accounting methods, problems relating to taxation and determination of long term leases are pertinent, and will be discussed under topic headings.
Capitalization.

Unfortunately, capitalization of long term leases under present legislation often will result in decreased tax benefits. The decision to decrease monetary benefits, while it may be theoretically desirable, must be taken seriously. Where the lease is obviously tantamount to a purchase, or where property rights are involved, or where the lease is non-cancellable, or where equity is accumulated, or where the useful life of the asset is substantially involved, or where interest calculations are based on cost or fair market value, and the related obligation is a liability, then capitalization must be considered. However, the dividing line is not clear, and the tax disadvantage, as long as it exists, will serve to perpetuate the cloudiness. While it is possible to use one method for accounting purposes, and another for tax purposes, such a procedure might be open to criticism. It might involve discrimination.

Property Rights.

Property rights are not widely recognized. No definition has been accepted, and there is no accounting policy as such for them. They do involve use rights versus use and legal ownership rights. When should leased assets be regarded as purchases? In the long run, all business assets are consumed to earn income. Ownership is a legal

convenience only, the disadvantages of which may outweigh the advantages. The difference in consumption of an asset acquired under a non-cancellable lease for its useful life, with no residual value, and the same asset purchased, may be nil. There are non-legal property rights obviously obtained under long term leases, or even short term leases, giving the right to consume the property. Where these rights are high in relation to the life and cost of the property, then the lease may be a purchase.

**Non-Cancellable Leases.**

A long term lease may be non-cancellable over the major part of the useful life of the asset. Where this is the case, it would appear there are, to an extent, property rights involved. There is a difference of opinion as to whether all non-cancellable long term leases should be capitalized, or only those with substantial property rights.

**Useful Life of the Asset.**

Proponents of capitalization believe that where the major part of the useful life of an asset is obtained under lease, then there is a good case for capitalization. It is a matter of opinion as to at what point in its useful life an asset should be capitalized. Opponents to capitalization would say that leases may be nothing more than executory contracts, and that rights and obligations related to unperformed portions of executory contracts do not represent assets and liabilities.
Equity Accumulation.

Where a material equity in the property is created, then the lease may be intended as a purchase. This is reasonable, because few would pay more for an asset than they had to, but again, the drawing line between normal rentals and excessive rentals indicating material equity is not easy.

Special Needs.

Where the property was designed to meet the special needs of the lessee, probably usable only for that purpose and only by the lessee, then the case for capitalization would appear to be strong.

Purchase Option.

The provision of a purchase option, particularly one where the residual value was below the fair market value would of course indicate an intention of purchase.

Non-Arms-Length Transactions.

Long term leases, and particularly those associated with a sale and leaseback between related individuals or companies are often made primarily for tax advantage. There is provision now, under Sections 12 and 137 of the Canadian Income Tax Act, to disallow extreme examples of such transactions, or to treat them as purchases and sales.

Renewal Options.

There are differences of opinion among accountants as to
whether renewal options should be considered in discounting future rental payments. This is a matter of opinion, occasioned by the extreme diversity of leases. However, where option terms are ultra-favorable, there would be the presumption that they will be exercised.

_Gains And Losses From Sale and Leaseback._

Should a gain or loss be taken into account in the year of the transaction, or should it be amortized over the term of the leaseback? The Research Committee believes that, as a financial arrangement, amortization would usually be the preferable method of accounting.  

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CHAPTER 12

CURRENT TRENDS IN ACCOUNTING - UNITED STATES.

The United States is perhaps fortunate in having continuously developed legislation with respect to taxation of long term leases. In Canada, questionable legislation was discarded, and now there is the ever present likelihood of renewed activity in what is generally acknowledged to be an inequitable tax area. However, in part due to this uncertainty, in part due to equivocation in the United States, in part due to current practice and research committee proposals, there is the definite probability that Canadian accountants may take the lead in the formulation of rules for the determination and presentation of long term leases.

The theoretical framework for lease accounting is gradually becoming clarified. Perhaps the most popularly accepted definition of an asset is that given by Sprouse and Moonitz - "Assets represent expected future economic benefits, rights to which have been acquired by the enterprise as a result of some current or past transaction." ¹

This is the future service potential concept of assets, developed by Canning in 1929, in his asset definition "... any future service in money or any future service convertible into money (except those...

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services arising from contracts the two sides of which are proportionately unperformed) the beneficial interest in which is legally or equitably secured to some person or set of persons." Canning later felt that the definition would be improved if the parenthetical material was eliminated. Under the traditional view, most writers did not consider that an executory consideration constituted an accounting transaction. However, under the expanded transactions concept, writers such as Rappaport, supported by Vatter, maintained that "an exchange of legally enforceable promises or rights gives rise to assets and liabilities under the transaction concept." With use of the above concepts, Wojdak has developed a theoretical basis which accommodates executory contracts. "The exchange of promises at the signing of the contract represents an exchange of rights to future service potentials, and thus is a valid point at which to recognize assets and liabilities."4

A contrast to the theoretical trend concerning executory contracts and long term lease accounting is given by reports of the American Institute of Certified Public Accountants. They first recognized the

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importance of long term leases in Research Bulletin No. 38, issued in 1949, which admitted that "it has not been the usual practice for companies renting property to disclose in financial statements either the existence of leases or the annual rentals thereunder...."\(^5\), and suggested that "where it is clearly evident that the transaction involved is in substance a purchase, then the leased property should be included among the assets...."\(^6\), and also that where this was not the case, certain particulars should be shown in the footnotes - "Not only in the year in which the transaction originates, but also as long thereafter as the amounts involved are material."\(^7\)

John H. Myers has since observed four developments:

(a) leasing has grown in importance and in multiplicity of forms;

(b) disclosure in notes to the financial statements has become a matter of course on a basis equal to or, in a great many cases, less than the minimum recommended in the Bulletin;

(c) the financial analysts have sought more information than is recommended; and

(d) the balance sheet presentation of leases which were in substance purchases has been almost non-existent.\(^8\)


\(^{5}\) Research Bulletin No. 38, American Institute of Certified Public Accountants, 1949, Paragraph 3.
Dr. Myers recommended that all non-cancellable long term lease rights and commitments should be capitalized and shown in the lessee's balance sheet. Further, if the lease covered substantially the entire useful life of the property, it would constitute the acquisition of an asset. In 1964, the Accounting Principles Board of the American Institute of Certified Public Accountants issued its much criticized Opinion No. 5, in which it stated that "the rights and obligations related to unperformed portions of executory contracts are not recognized as assets and liabilities in financial statements as presently understood." In all fairness, they extended and clarified the kinds of leases which should be regarded as equivalent to purchases of property. These were leases that contained renewal options covering the useful life of the property.

6. Ibid., Paragraph 3.
7. Ibid., Paragraph 3.
8. Myers, J. H., Reporting of Leases in Financial Statements, Accounting Research Study No. 4, American Institute of Certified Public Accountants, 1962, p. 3.
9. Ibid., p. 5.
at substantially less than fair rental value, and leases that gave the right of acquisition at substantially less than fair market value.

Other factors were where the property was acquired by the lessor to meet the special needs of the lessee and would probably be usable only by the latter, where the lease term corresponded to the useful life of the property and the lessee paid taxes, insurance, maintenance and other costs usually incidental to ownership, where the lessee guaranteed the obligations of the lessor respecting the property, and where the lessee and lessor were related.

As of 1968, the following standards have been used to indicate if agreements are leases:

1. The lease term including extensions must be at least two years less than the useful life of the property;

2. Estimated value of the property at the end of the lease, including extensions, must be at least 15% of its original cost;

3. Lease rental payments must be level over the entire term of the lease;

4. Guideline depreciation (in the United States, there are a number of methods of depreciation from which to choose, but once a method is chosen, it must be adhered to) may not be used;

5. There can be an option to purchase at the end of the lease term, but it must be at its fair market value at that time;
(6) closing agreements must be entered into by each party to the transaction (i.e. - assets may not be retained indefinitely).

There appear to be many pressures on the American Institute of Certified Public Accountants to revise Opinion #5 of its Research Board. Few writers support the finding, and among the opposition arguments are the following:

(a) it renders guidelines ineffectual;

(b) it lacks theoretical justification;

(c) it ignores property rights;

(d) it ignores creation of material equity in the property;

(e) it distorts ratios by omission, in that legal liabilities are not shown on the face of the balance sheet;

(f) it was not a unanimous opinion;

(g) leases are no more an executory contract than an instalment purchase; and

(h) the manner of write off should be chosen with reference to the useful life of the asset, and not according to the method whereby the related obligation is discharged.

Pressures have also been exerted from such groups as the American Association of Bank Lending Officers, who have expressed considerable dissatisfaction with Opinion #5.

In England, Scotland, Wales, Australia and New Zealand, the impact of long term leases has not yet raised the controversy over presentation that it has in Canada and in the United States. The English Hire-Purchase Act of 1938, relating to long term leases, was designed to help with small appliances, and other purchases less than 100 pounds, and less than 500 pounds in the case of autos and rolling stock. For tax purposes, where there was a purchase option, the asset was deemed to be a purchase, and interest could not be taken into account in the calculation of capital cost allowances. In 1963, the observation was made that "until disclosure becomes obligatory in this country, it is doubtful whether accountants will have much success in persuading clients to report a type of transaction which many companies would prefer to hide." ¹

In Scotland, the Companies Act of 1967 states that "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities, and that there shall be stated the general nature of contingent liabilities and the aggregate amount thereof. ²

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² Companies Act of 1967, Scotland, Paragraphs 11(5) and 27.
However, this has been interpreted by one writer, correctly or incorrectly, as a liability at the balance sheet date, where "future liabilities" have no place in a balance sheet. 3

In Australia, the Deputy Governor of the Reserve Bank of Australia, in 1968, said that "loan financing was a relatively new development in Australia, but had become increasingly important over recent years, particularly in dealings in the industrial equipment field." 4

In New Zealand, it has been noted that a lease with an option to purchase is recorded as a purchase at the time the agreement is signed, being "accepted common practice." 5


APPLICATIONS OF THE CARTER REPORT

(ROYAL COMMISSION ON TAXATION)

The Report of the Royal Commission on Taxation, known as the Carter Report, reviewed the subject of lease-options (rather than long term leases). The review will be quoted in detail, and then commented upon.

"The subject of capital cost allowance cannot be closed without considering leasing arrangements under which the lessee has some right to acquire the property. By renting a long term asset instead of owning it, a taxpayer may enjoy most benefits of ownership and yet obtain a faster deduction of its cost for tax purposes in the form of rent than he would have obtained in the form of capital cost allowance had he owned the asset. If the lessor is subject to all the normal requirements of the capital cost allowance system in respect of the asset, this arrangement need not be of particular concern to the tax authorities. If, however, the lessor is able to accelerate the deduction of the cost of the asset, either by way of terminal loss upon disposal of the fixed asset, or as an inventory loss upon transfer of title to the lessee, the net effect is to achieve a faster write-off of the long term asset and thereby to defeat the purpose of the capital cost allowance system.

"Prior to 1963, there were provisions in a previous Section 18
of the Act which were intended to prevent lessees under lease option agreements from obtaining faster write-offs on capital assets covered by such agreements than would have been available if they had been purchased outright. In effect, the provision treated such agreements as agreements for sale of such assets, and treated payments thereunder as payments on account of the purchase price rather than as rental payments for the use of the property. The lessee's deductions from income in respect of such payments were limited to the equivalent of the capital cost allowances on the portion of the purchase price attributable to depreciable property. However, many shortcomings remained in the section despite various amendments and it was finally repealed in 1963.

"While the leasing business is based primarily on financial, rather than taxation considerations, once a leasing arrangement is contemplated there is an opportunity to obtain tax advantages. With the widespread use of leasing today, the treatment of such arrangements for tax purposes is a matter therefore of great concern if the capital cost allowance system is not to be undermined. In reviewing the problem, we realized that, with the great variety of terms on which leasing arrangements can be drawn, it would be impossible, as was

found under the repealed provision, to provide detailed legislative rules to deal with the situation. This would be particularly true if the rules were based on possible events to take place in the future. At the same time, we believe that some specific provisions are required to control the tax postponement possibilities under this type of agreement.

"We recommend that a specific provision should be introduced into the legislation to allow deduction for rentals of long term assets that the lessee has a right to acquire only to the extent that they are reasonable and that any excess be treated when paid as being on account of the purchase price of the asset. If the asset was a depreciable asset, this excess would be eligible for capital cost allowance when the asset was acquired, or would be deductible if the option lapsed. We also recommend that it should be specifically provided that where a lessee acquired, at less than its fair market value at the time of acquisition, an asset which he had been renting, such deficiency in the purchase price should be regarded as a reduction of rents previously claimed, except to the extent of the rents disallowed under the first part of our proposal, and the amount thereof should be brought into income immediately with an offsetting amount to be amortized in the future under the capital cost allowance regulations."
Criticism.

(A) The recommendations of the Carter Commission seem to be based on the premise of a purchase option, or a purchase subsequent to a lease. "Assets that the lessee has a right to acquire" do not appear to refer to property rights, making non-relevant the useful life, equity accumulation, intent, and other criteria which do not depend upon the legal right of acquisition, but do depend upon the right of use. Legislation based upon the purchase option, from both a theoretical and practical standpoint, has little chance of success.

(B) "If the lessor is subject to all the normal requirements of the capital cost allowance system in respect of the asset, this arrangement need not be of particular concern to the tax authorities." This is an invalid assumption. The lessor and lessee may be at opposite ends of the income tax bracket. Also, if A buys, and leases to B, who leases to C, and so on, because A complies with normal requirements, this sentence appears to say it does not matter what B...Z do. This reasoning escapes the writer. The lessor, under a sale and lease-back arrangement, can have a tremendous tax advantage, even greater than that of the lessee. The report does not mention the very serious economic disadvantage imposed upon the business community, whereby in order to gain tax advantage, the lessee must pay much more for the asset than he would by purchase. It does not mention that the incidence
of an equitable tax, sufficient to counteract the undue tax benefits now available, would not fall heavily on the business community, but would largely be offset by increased business efficiency.

(C) "We recommend......deduction for rentals of......assets that the lessee has a right to acquire...." The right to acquire is not necessary for practical ownership; the right of use may be equally important.

(D) "......only to the extent that they are reasonable...." Fair market value, or its equivalent in discounted future payments, should be in all legislation of this nature.

(E) "......any excess be treated when paid as being on account of the purchase price....". This should also be subject to fair market value, otherwise some variation of over or under priced assets being sold or purchased for tax advantage could result.

(F) There is no recognition that tax deductions are available if improved land is leased, but not if it is owned. It might be more equitable if the imputed cost of land was made an allowable expense, or be disallowed when included in lease expense.

(G) No definition of long term assets is given. Unless otherwise defined, they would presumably follow the pattern of established accounting practice, whereby the rule of one year is used.
CHAPTER 15

SUGGESTED CHANGE IN TAXATION OF LONG TERM LEASES.

Realistic suggestions for tax reform of long term leases are necessarily tied in with asset capitalization, which in turn relates to balance sheet presentation. In other words, taxation of long term leases as purchases must fall under the Capital Cost Allowance system. Taxation must also relate to current accounting practice and principles; if the measure is unrealistic, or too far ahead of accepted practices, then avoidance or exasperation will result.

Objections to balance sheet presentation will first be examined. These objections seem to based on five points, each of which is difficult to support. They are as follows:

(a) The rights to leased property are not ownership rights, and are not assets. It is undeniable, however, that these rights do exist, and it has been established that legal ownership is not required for capitalization purposes.

(b) Judgments will be too subjective. Valuations based on fair market value have been and accepted for decades.

(c) Technical accounting difficulties will arise with maintenance leases, as to what part are capital, and what part expense. This may be an onerous problem, but costs can be established. Fair
market value can be used as a criterion.

(d) It would have adverse economic consequences, especially to the lessee. This argument is now insupportable with respect to balance sheet presentation. It is accepted practice that information required be shown as footnotes to the balance sheet, if not in the balance sheet proper. Also, inordinate secrecy may not be in the best interests of the shareholders.

(e) Many economic advantages would disappear. However, ratios and comparisons would be much more accurate, and economic advantage would accrue to the economy as a whole.

(f) By precedent, long term leases have not been recognized as asset purchases. This imperfect fortress of logic has been assaulted many times, and is in very weak condition. Precedent must give way to changing conditions and times.

A concept with some merit is that assets acquired under long term lease be grouped with other property accounts in the balance sheet, but separately classified to show existence of the lease arrangement, and that supporting data be given in notes to the financial statements. There are objections to his procedure; a halfway solution is seldom satisfactory.

What form of legislation regarding long term leases would satisfy the objective of controlling the tax postponement and avoidance
possibilities now afforded? Would it, as asserted by the Carter report, be impossible, as was found under the repealed provision, to provide detailed legislative rules to deal with the situation? In the writer's opinion, the situation can be dealt with, and detailed legislative rules are not required. There is no method of taxation which is, or can be, entirely equitable. Name two people who have precisely the same ability to pay precisely the same tax, and that argument will not only be refuted, but it will be shown that circumstances change every day. Optimum equity in taxation is to be strived for, and this does not necessarily require detailed rules.

There is no doubt that the system of Capital Cost Allowances is strained. Eric Kierans suggested in a television interview that the system might be dropped entirely, and the corporate rate of tax reduced in lieu of allowances, thus reducing undue advantage gained by large corporations. This suggestion lacks justification; equity and fairness must be objectives.

The following suggested tax legislation is simple and concise. It should be difficult to misinterpret, and is far more equitable than the present legislation allowing tax advantage to long term leases. It would result in very large revenue increases to the government via

decreased allowable deductions. Moreover, the incidence of the tax would fall only lightly on business enterprise; the decreased cost of purchases as compared to leased assets could bear the brunt of the tax. It would strengthen the capital cost allowance system by removing one important method of avoidance, or by reducing the strain to manageable proportions. The suggested legislation is as follows:

"Where an asset is leased, and the gross amount payable payable under the lease for that asset, including amounts payable under renewal options, is greater than 90% of the fair market value of the asset at the time the lease became effective, then that lease shall be deemed to be a purchase at an amount equal to the fair market value of the asset at the purchase date."

On first reading, this might appear to be very reasonable. After all, if over 90% of the asset is to be paid for, would it not be closely related to a purchase? On second reading, it might be noted that there is no provision for present value discounting, and for longer term contracts, the legislation could be quite effective. Most realty contracts are for longer terms, and the tax avoidance aspects of leases involving land would be counteracted. Section 12(2) of the Income Tax Act could be relied upon to take care of such devices as treating land and improvements separately in the same lease contract, and assigning disproportionate rentals to land.
Criteria have been established by Canadian and American courts, and by Research Committees, to ascertain when leases are really conditional sales contracts. How does this suggestion relate to such criteria?

**Equity Accumulation.**

In the majority of cases, it would be difficult to reasonably show that where over 90% of the value of an asset has been paid, or was payable, there was no equity in that asset. There is normally some equity accumulation when less than 90% of fair market value is considered, and there would be very few cases where no equity would be involved.

**Economic Effect.**

It is well established that in most cases, when tax advantage is eliminated, leasing is more expensive than purchasing. The economic effect of now acquiring an asset at a reduced price would be very beneficial to the community as a whole. Increased government revenues would be largely offset by decreased direct costs.

**Business Intent.**

Where the intent was to use an asset to such an extent that in excess of 90% of its fair market value would be paid for if leased, then the function of a purchase would be inherent in the contract in most cases.
Useful Life

One benefit of the study of American experience is to ascertain areas in which they have had legislative difficulty. Attempts to establish useful life of assets is one such area. While useful life of the asset is not directly involved in this suggestion, it may be assumed that the residual value of non-realty leases would not be large, and since the greater part of the economic life was used or usable, then the greater part of the useful life would be likewise. Realty leases, and in particular those involving land, would be disadvantaged to a greater extent, but the taxation concept is fair, whereas the present avoidance opportunity is not.

Property Rights.

When equipment leases are considered, the 90% rule will normally assure that 'consumption' of the asset is more similar than not to a purchase, most of the rights derived from available use of the asset being exercised, or exercisable. Under realty leases, the property rights available to the lessee-purchaser may not be as large, but are nevertheless substantial, and more so when the value of land is eliminated.

Community Acceptance.

A tax which is not acceptable to the community is not a good
tax. A tax which is not enforceable is not a good tax. This suggestion is both acceptable and enforceable. Accountants and auditors are prepared for this type of legislation, and their clients, in most cases, are highly aware of current trends. To quote again from the recent preliminary discussions of the Research Committee of the Canadian Institute of Chartered Accountants:

"...as a general rule, the inclusion of leased property rights as assets and the related obligation as liabilities in the balance sheet provides a fairer presentation of the resources held for use within the business and of its financial commitments than is achieved by note disclosures."

Legislation is but a small step away from the above mentioned quotation. The foundations have been laid. It is only left to find the proper procedure. The writer has presented his solution.

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