RECENT DEVELOPMENTS IN "FINANCING" — LEVERAGED LEASING

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The purpose of this paper is to convey some idea of what leveraged leasing is all about. We will also attempt to give some thoughts as to the application of leveraged leasing in the mining and petroleum industry but we will leave it to you to apply the principles discussed below to the special requirements of the mining industry.

We do not intend to be unduly legalistic not only because this will make our task easier but also it is hoped that the paper may, as a consequence, be more interesting.

1. BACKGROUND AND APPLICATION

Leasing as a means of finance will no doubt be familiar to you all. However, the concept of leveraged leasing is a relatively recent development.

The technique was introduced in the United States by United States Leasing International in 1963. It was initially used by railroad and airline companies and its major growth occurred between 1971 and 1974 when it was realised that capital intensive companies could finance the full cost of equipment at a lower effective cost than traditional methods of financing.

The first leveraged lease in Australia was completed in 1974; this involved the leasing of a smelter in the Northern Territory. Since that time leveraged leasing has come to be accepted in the finance industry as a financing device. Its benefits were enhanced by the re-introduction of the investment allowance in 1976. However as at 30 June 1978 the investment allowance will be reduced from 40 per cent to 20 per cent.

Leveraged leasing is most suitable to major new projects where a large proportion of the expenditure will relate to plant with high rates of depreciation. Of course in time of tight liquidity the technique may be used to refinance an existing project which has been financed by other borrowings. In that case as the plant is not new plant it is not then eligible equipment for the purposes of s.82AB of the Income Tax Assessment Act 1936 (Cw.) the investment allowance will not be available to the lessor; leasing costs will therefore be greater.

Because of the complexity of the documentation and the associated costs and fees, leveraged leasing will normally only be utilised in respect to capital equipment of substantial cost. It is neither possible nor meaningful to specify a minimum figure but it is unlikely that the technique would be used for transactions of less than $1 million.

The deductions available by way of depreciation and the investment allowance on appropriate capital machinery plant or equipment are at this time so high that a new capital project may not be able to immediately absorb them. Therefore, unless the rest of the operator's business can absorb the available deductions the operator has two alternatives, namely, to retain the excess deductions as carry forward losses under s.80 or in the case of a mining company as residual capital expenditure, or to enter into a leveraged lease transaction.

The credit standing, track record and experience of the lessee is most important in leveraged leasing and therefore the technique will probably only be available in the mining context to a limited number of prime rated companies which

can demonstrate an ability to meet lease obligations whether or not the project is viable. This was demonstrated in the Northern Territory smelter lease where the lessee decided that due mainly to falling copper prices it was more economic to close down the smelter than to continue to incur the heavy costs associated with operating the smelter.

This credit requirement contrasts with project financing where the financial strength of the borrower may be less important. In project financing the lenders look, in the main, to the viability of the project as evidenced by long term sales contracts. However, there may be cases where leveraged leasing and project financing could be utilised together in the same project.

One reason why the credit standing of the lessee is so important is because of the high risk undertaken by the owner/lessor which, having mortgaged the equipment and its interest in the lease thereof then relies on lease rentals to service borrowings and ultimately to redeem its asset. Also the security taken by the lender may be difficult to realise in the event of default.

In terms of security offered by an owner/lessor to a lender the most suitable transactions will be the financing of moveables such as planes, ships, vehicles, rolling stock and other plant machinery and equipment having a wide application, rather than specialised plant or equipment constructed to meet the lessee's particular requirements or in respect to which the lessee alone has the necessary knowhow; such specialised plant or equipment may be very difficult to realise in the event of default.

2. LEVERAGED LEASING DEFINED — THE PARTIES AND THEIR INTERRELATIONSHIP

As presently understood in Australia a leveraged lease is a chattel lease whereby the lessee agrees to pay to the lessor a rent, calculated having particular regard to the lessor's tax benefits described below, which is sufficient to reimburse the lessor for the proportion of the cost of acquiring the asset contributed by the lessor, and the lessor's borrowings, including interest and all associated costs, to finance the remaining acquisition costs, and allows an agreed profit or yield to the lessor.

This definition is not intended to be exhaustive and it may be that leveraged leasing can be extended beyond chattels although the tax benefits would thereby reduce.

The principal characteristics which distinguish leveraged leasing from normal leasing are that the acquisition cost is leveraged between the lessor/owner and a third party lender and that the loan is made on a non-recourse basis. The lessor's borrowing and the security given to the lender is therefore part of a total lease package which we now consider in more detail.

In a typical leveraged lease the parties will be:

(1) The lessee. The lessee selects the equipment, orders it or arranges that the lessor places the order and pays a rent for its use. Within the limits of consumer and trade practices legislation the lessee is made responsible for maintenance of the equipment, insurance and compliance with all statutory requirements and indemnifies the lessor against all claims arising by virtue of the lessor's ownership and the lessee's use of the equipment.

(2) The lessor. The lessor invests a proportion of the capital cost, usually between 20 per cent and 40 per cent, becomes the owner of the equipment and utilises all the tax benefits. Typically the lessor will be a bank or a financial institution with sufficient taxable income to benefit from the deductions available by

virtue of ownership and thereby able to pass on to the lessee a lower effective cost than would be available through other traditional methods of financing.

(3) The lender. The lender makes a non-recourse loan to the lessor of between 60 per cent and 80 per cent of the equipment cost and takes security over the equipment and the lessor's rights under the lease. That is, without personal liability, the lessor assigns to the lender by way of security all its right title and interest in and to the leased equipment and to the lease and to all lease payments. Rental payments are applied first towards repayment of principal and payment of interest and any remaining surplus is payable to the lessor.

(4) The Manager. The manager as the packager arranges the transaction so as to marry the various requirements of the parties (a most difficult task as will be seen later) and arranges all lease and security documentation. It is the manager's task to blend the specific requirements of the parties so as to achieve:

(a) a satisfactory cost to the lessee;
(b) a fixed return to the lender with satisfactory security; and
(c) a satisfactory return on investment to the lessor.

During the currency of the lease the manager usually:

(a) arranges for the rental payments to be disbursed in the correct manner;
(b) keeps all records of the lessor's investment;
(c) arranges taxation returns on behalf of the lessor;
(d) periodically reports on the lessee's financial position to the lessor;
(e) handles the disposal of the equipment at the expiration of the lease term or upon default; and
(f) otherwise acts on behalf of the lessor in the event of default.

It will be seen that there is no direct nexus between lender and lessee, although some lenders require the lessee to be joined as party to the security document so as to give to the lender direct warranties and covenants. The lessee does not undertake any personal liability in favour of the lender for repayment of the loan.

On the other hand the lender has no right of recourse against the lessor for default under the loan arrangements except to the extent that the lessor fails to pass on to the lender any rental payments received from the lessee or if it is otherwise guilty of gross neglect. What this means is that if the lessee defaults under the lease and as a result there are no funds being provided by the lessee to repay the loan then the lender is obliged to rely on its security over the equipment and the lease.

The expressions "lessor" and "lender" used in this paper correspond with the respective terms "equity participants" and "debt participants" frequently used in writings on this subject.

3. OBJECTIVES OF PARTIES — ADVANTAGES AND DISADVANTAGES OF LEVERAGED LEASING

A. Lessee

(1) Advantages

(a) The tax benefits available to the lessor by way of depreciation and investment allowance reduce the lessee's cost of borrowing because in the early years of the lease the tax deductions available to the lessor exceed the lease payments thereby deferring the lessor's liability to pay tax. This will enable the lessor to

use retained funds elsewhere resulting in a capacity for lower cost funding to the lessee.

The above assumes that the investment allowance is claimed by the lessor. This allowance can be passed on to the lessee direct in an appropriate case with a consequent increase in rental payments.

(b) The lessee can "finance" 100 per cent of the cost of the leased plant or equipment whilst in other methods of borrowing the lessee may only be able to borrow say 60 per cent to 70 per cent of this cost.

We should comment here, that leveraged leasing is generally used in respect to depreciable plant and equipment and that as a consequence the other costs involved in a major project such as ancillary improvements, services and other development work will usually have to be financed by other methods. We understand that this would be the case in the fields of mining and petroleum and may be a limiting factor to the use of leveraged leasing in these areas particularly because of the complexities which could be involved by virtue of the interrelationship between the financiers of the leveraged lease and the other lenders.

The problems in having a multiplicity of lenders will be of less significance where the lease is limited to plant machinery and equipment which are independent of the mining or exploration programme. For example, earthmoving equipment, heavy vehicles, loaders, containers, rolling stock and other parts of the infrastructure of the mining operations would be clearly distinct lettable items.

(c) The lessee obtains a deduction for the whole of the lease payments whilst in a loan transaction only the interest would be deductible.

(d) The term of a leveraged lease would usually be longer than the term available under a loan arrangement.

(2) Disadvantages

(a) The lessee is deprived of ownership and gives up depreciation rights. However, it should be remembered that depreciation is spread in devaluing currency (as a result of inflation) claimed gradually over the life of the asset. While the value of our currency declines the benefit of the deduction also declines. Lease payments, on the other hand, are deductible in full in the year of expenditure.

(b) The lessee has no guarantee that it will be able to acquire the equipment at the expiration of the term. This has proved a stumbling block to many lessees who are not willing to abandon the security of true ownership in favour of the uncertainty of tenure involved in a lease. You will be aware that the Income Tax Department will not recognise a lease as a true lease for tax purposes if the lessee is entitled to acquire the equipment prior to or at the expiration of the term. However, the lessee is free to bid at any auction held by the lessor and may well be the most likely or the only bidder as the equipment will normally be of particular value to it.

It may be that methods are or become available to protect the lessee's position as to the equipment.

(c) The typical equipment lease provides for regular lease payments without regard to the lessee's cash flow and this can give rise to periods of tight liquidity for the lessee.

(d) If the lessee's taxable income, from all sources, exceeds its expectations early in the lease it will be unable to utilise the tax benefits of ownership to offset this income.

(e) The lease documentation often gives extensive powers to the lessor in respect to the equipment in the nature of rights of inspection and to require the lessee to carry out repairs. Lessees sometimes resent this outside interference because they not unreasonably believe that they know their job better than the financiers.

B. Lessor

(1) Advantages

(a) The lessor obtains the tax advantages of ownership namely depreciation, the investment allowance, if applicable, and a deduction for interest on borrowings, notwithstanding that it only contributes a proportion of the cost.

(b) The lessor remains owner of the equipment at the expiration of the term.

(c) The lessor's borrowing is non-recourse.

(d) Because of the tax benefits the true yield available to the lessor should be greater than it would achieve in other forms of investment notwithstanding the Federal Government's requirement that benefits be passed on to the lessee.

(2) Disadvantages

(a) The lessor is not a lender and takes all the risks attendant upon an owner including its cash investment.

(b) The lessor assigns all its powers and rights under the lease to the lender resulting in most decision making resting with the lender.

(c) The lessor bears the whole of the risk for the residual value applied to the leased equipment. For this reason, lessors tend to be cautious in their estimate of residual values thereby marginally increasing the rental payments during the lease term.

(d) The lessor normally takes the risk of a change in its rate of taxation. In some instances the lessee might be persuaded to indemnify the lessor against this risk.

We have referred to the taxation benefits available to the lessor and the fact that these advantages give rise to a reduced cost to the lessee. How does this work? At the commencement of the lease there is a negative tax liability. In other words, the tax benefits of ownership will exceed the incoming lease payments. The benefit of this negative tax liability depends upon the availability of taxable income against which this loss can be offset. The effect is that the early tax losses delay the payment of tax. They do not avoid payment of tax but the deferral gives rise to a present monetary value to the lessor which can be passed on to the lessee in the form of lower rental.

If the lessor's total assessable income or its rate of tax decreases in the early stages of the lease this will give rise to a negative effect on the lessor's yield because the lessor's ability to absorb the income tax deductions will be reduced. Conversely if the lessor's total assessable income or its rate of tax increases in the early stages of the lease the lessor's yield will be increased. The converse is true in the later stages of the lease.

C. The Lender

The main advantages to the lender are that because of the special characteristics of non-recourse lending in leveraged leasing and the consequent risk undertaken by the lender its interest rate may be marginally higher than for a comparable commercial loan and notwithstanding "non-recourse" the borrowers are usually blue chip companies.

The disadvantages are that the loan is without recourse to the borrower/lessor and the security may be difficult to realise for the reasons already mentioned.

4. STRUCTURE

The structuring of a leveraged lease will be dependant upon a number of factors and in particular the policy requirements of the lessor. The typical and available types of structuring are as follows:

(1) a tax partnership between the lessors (if more than one) whereunder the parties directly own the asset and directly lease and borrow.

(2) a tax partnership, as before, but a nominee and agent is appointed and authorised to acquire the asset to borrow and to lease for and on behalf of the lessors. In this case there is in effect the relationship of principal and agent but in addition as a strict matter of law, the agent having the legal title would be a trustee for the lessor parties.

(3) Again, a tax partnership, and the appointment of a trustee with discretionary powers to acquire assets lease and mortgage. The intent of course is that the trustee acquires a specific asset and enters into the lease and loan arrangements for the partnership. Such a trustee may be made available by the manager for or may be a company incorporated by the lessors for the specific transaction.

The intent of course in the structuring is to ensure that all the tax benefits are available directly into the hands of the lessors to be claimed against their separate income from other sources. If any trust method is utilised care must be taken to ensure that income and allowable deductions are not locked into the trust.

The choice of structure will influence and affect the requirements for and the drafting of the subsequent documentation. In particular it will affect the form and content of the security to be taken by the lender.

5. DOCUMENTATION AND SPECIAL CHARACTERISTICS

A. The documentation will normally involve the following:

(1) Purchase Agreement

This applies in a lease-back transaction. In some cases the lessor will take title direct from the supplier or manufacturer.

(2) Lease

This is the main document and sets out the lessee's obligations to the lessor. The interest of the lessor and the lender in relation to this document are for all practical purposes identical.

(3) Security

This usually involves a charge over the equipment, the lessor's rights under the lease and the benefit of any guarantee given in respect of the lease obligations.

(4) Partnership Agreement

The lessor parties (if more than one) are usually in partnership for tax purposes

for two reasons. First, the transaction is isolated so that the partnership can change the basis of depreciation without affecting the basis of depreciation claimed by the individual partners on their own separate assets. Second, the losses created are immediately available to the partners against their separate income.

B. Special Characteristics

Some of the distinguishing characteristics of the leveraged lease document are:

(1) As the lease is part of a total package, the lessee is usually liable for payment of all costs associated with the lessor's borrowings including any establishment fees, unused facility fees and in the case of off-shore loans any additional cost factors.

(2) Replacement parts become the property of the lessor. However, problems will arise where a major change is required to be made to the equipment. As the lessor and the lender are not committed to provide any further finance once the lease has commenced, the lessee will be responsible for financing the cost of any major replacements and if the expense is non-deductible the lessee may seek to retain ownership of the replacements so that the lessee gets the benefits of depreciation and investment allowance for the new items. The parties will have to reach agreement on a basis satisfactory to the Tax Commissioner whereby those items are deemed to be in the ownership of the lessee but become the property of the lessor upon termination of the lease. Alternatively, there may be a formula for division of the sale proceeds upon the sale of the equipment. In any event the lessor and lender will require to regain control of the whole of the equipment, including replacements deemed to be in the ownership of the lessee, upon default.

(3) Because the lenders look to the financial viability of the lessee from all its business operations rather than solely to the leased equipment itself, the financiers frequently require the lessee to provide regular financial information and other reports to enable them to monitor the lessee's financial position.

(4) Prior to entering into a lease it is usual for the manager to obtain a ruling from the Income Tax Department as to the underlying tax assumptions on which the transaction has been structured. The ruling will normally be sought on the following matters:

(a) the availability of depreciation at a particular rate;

(b) the availability of the investment allowance;

(c) the availability of a deduction for interest on the lessor's borrowings;

(d) the availability of a deduction to the lessee for the whole of the rental payments;

(e) the acceptance of the lessor partnership for tax purposes.

(5) Additionally the lessee will indemnify the lessor against any loss of the investment allowance, depreciation or other tax benefits as a result of any act or omission on the part of the lessee. Indemnities may also be given against any change in the lessor's rate of taxation. The extent to which indemnities are given in respect to taxation matters will always be a matter of negotiation between the parties.

(6) The lease will include a schedule setting out the pay-out at any time should a casualty occurrence, for example, loss or destruction of the equipment, occur so as to provide for the return to the lessor of the balance of its investment after paying out the lender. The lessee is required to insure against this liability.

Problems may arise as to whether or not a casualty occurrence has occurred and one way of dealing with this may be to leave the decision to the insurer.

(7) The lease includes a schedule of the amounts required to be paid to the lessor by way of liquidated damages upon default. One of the skills of the manager is to calculate the damages so as to truly compensate the lessor for the default.

The Security

The rights inter se of the lenders, if more than one, require negotiation in the same way as in any other consortium lending arrangement. The lenders may appoint a trustee to lend the funds and take the security on behalf of the lenders but in our experience this is not usual. Usually the lenders lend their proportion of the loan funds direct to the lessor/borrower or a nominee and share pro rata in all repayments although there is no reason why repayment schedules cannot be varied to meet particular requirements of the various lenders. The interest rates and the loan term can also vary as between different lenders in the same transaction.

Arrangements need to be made as to the action to be taken in the event of default and the lenders may appoint one of their number to act as manager for this purpose.

The other matter which requires resolution concerns what rights (if any) are to be left to the lessor. Is the lessor to be denied any right of action at all against the lessee until the lender has exhausted its remedies? The lender may take a course of action which is not in the best interests of the lessor. In this context it must be remembered that the lessor bears the risk of recovering the residual value and any precipitous action of the lender may be to the lessor's detriment.

For these reasons the lender usually allows some residual rights for the lessor including a right to notification from the lender of any proposed action thus giving the lessor the opportunity to either remedy a default or to pay out the lender and thereby regain control of the assets.

Security has become increasingly contentious in leveraged leasing transactions because some banks and institutions taking the position of lessor are reluctant to have securities registered against their names. Presumably they are concerned to remain anonymous as the registration of security may give a false impression to those unfamiliar with non recourse leveraged leasing.

The desire on the part of some lessors not to have security registered against them has given rise to a number of problems. If the security includes security given by a corporation over the equipment there is no doubt that it should be registered under the applicable Companies legislation. Failure to do so not only renders the security void against the liquidator and any creditor of the corporation giving the security but also renders the corporation and every officer thereof in default liable to a default penalty.

In some instances the lender might agree to take security over the lessor's rights under the lease only, and not on the equipment itself, but such a security may still require registration as being a charge over the book debts of the company. It is beyond the scope of this paper to examine whether the provisions of s.100(3)(h) of the Companies Act relating to a charge on book debts would apply where the only security taken is a security over the lessor's rights under the lease. Suffice to say that opinions will differ on this question but why take any risk if the lender wishes to be fully secured.

There may be alternative ways of providing security to the lender whilst preserving the anonymity of the lessor for example by utilising a trustee or an agen' However, this may give rise to arguments as to whether both the legal and beneficial interests in the relevant assets need be or are secured to the lender. Perhaps the provisions of the Partnership Act may be of assistance in this area.

However, there is already a trend for lenders to make unsecured loans in leveraged lease transactions.

Because of the usual financial strength of the lessor participants, lenders may not always be over-concerned as to whether security taken for loan funds is liable to be avoided for lack of registration; as a practical matter it seems the problem is hardly likely to arise. Therefore, lenders may be prepared to accept undertakings, enforceable in contract, by lessors to pay to the lender any rentals payable to or received by the lessor from the lessee in reduction of the lessor's borrowings thus allowing a limited right of recourse against the lessor for failure to honour such undertakings. Additionally, the lessor may appoint the lender its attorney to enforce performance of the lease and to exercise the lessor's powers under the lease document. Such a power would be effective to allow the lender to sell the equipment and apply the proceeds in reduction of the mortgage debt so long as there are no competing claims against the lessor or any of the lessor participants. In the event of the liquidation of any lessor it would be argued by the creditors that unless the lender took a registered security, the lender could not claim the proceeds of sale of the equipment in priority to the unsecured creditors.

To protect against the unlikely event of the liquidation of the lessor, or any of them, and the consequent possibility that any payments of lease rentals or proceeds of sale direct to the lender may be set aside, it may be possible to obtain a limited direct undertaking from the lessee in favour of the lender to make rental payments direct to the lender in the event of any default on the part of the lessor. The payments would be deemed to be in satisfaction of the lessee's obligation to the lessor under the equipment lease and, in order to ensure that there is no possibility of a double liability in the books of the lessee, it would be necessary to ensure that the liability undertaken by the lessee to the lender could not exceed the corresponding liability under the equipment lease.

Such an approach again seems liable to challenge by unsecured creditors of the lessor who might argue that in the absence of registration of any security in favour of the lender, the rentals payable under the equipment lease should be available for the other unsecured creditors of the lessor and that the lender should rank as an unsecured creditor of the lessor for repayment of the loan.

The market will dictate the future course which will have to be adopted in the taking of security and in so doing will blend the particular individual requirements of lender, lessor and lessee respectively.

6. APPLICATION TO MINING AND PETROLEUM VENTURES

We do not presume to comment with authority on the types of plant machinery or equipment which might best be financed through leveraged leasing in the mining and petroleum industry. The decision to be taken in each case will involve a detailed comparison by the lessee's financial advisers with other borrowing methods having regard to the very generous reductions available for capital expenditures in the exploration for, extracting, treatment and transporting of minerals.

Subject to this qualification, some comments may be useful.

(1) We have already said that leveraged leasing will probably only apply in the case of prime credit companies. This may mean that this technique will not be available to joint venture companies or other companies only incorporated for the purpose of a particular project unless satisfactory guarantees are available.

(2) Mention was made earlier of the problems which may arise where the leased asset or assets are part of a large project which is also financed by other methods. The rights and interests of the various lenders would require clarification. If the parties involved in a leveraged lease are concerned to ensure that the leased assets are capable of being disposed of or otherwise dealt with independently of any other assets, then the application of leveraged leasing may be limited to situations where the asset proposed to be leased is physically separate and independent from the other mining activities. This was the case in the Northern Territory Smelter mentioned earlier (although some of the structural items in the Smelter which did not qualify for depreciation were financed by other methods).

(3) The investment allowance is, of course, a major attraction in any form of leasing. However, its significance is less important since 30 June 1978 when the allowance dropped from 40 per cent to 20 per cent of capital cost. Hence it is important to determine whether or not the investment allowance is available in any particular transaction. For example the allowance is not available in respect to the following items:

(a) structural improvements, with certain exceptions, (s.82AE)

(b) plant or articles for use in connection with amusement, recreation or sport (s.82AF(2)(i) and (ii))

(c) wharves or jetties (s.82AF(2)(h))

(d) plant or articles referred to in s.62AA(3)(h) or (i) and s.62AB(3)(h).

It is appropriate here to add that in addition to the usual tests the following three particular requirements must be made to take up the benefit of the 40 per cent investment allowance.

(a) The relevant items must have been ordered on or before 30 June 1978.

(b) The order must have been placed by the ultimate owner/lessor in the leveraged lease transaction.

(c) The items must have been installed ready for use or must have been in use on or prior to 30 June 1979.

(4) It will normally be found that leveraged leasing is more appropriate in relation to plant and equipment with high rates of depreciation.

(5) The income tax provisions relating to mining, petroleum and transport facilities set out in Divisions 10, 10AA and 10AAA respectively are most complex and have been dealt with adequately in other papers. What follows is a very broad summary of the basic thrust of these divisions bearing in mind that under Divisions 10 and 10AA only a company carrying on prescribed mining or exploration operations is entitled to claim these tax benefits.

(a) Both Divisions 10 and 10AA distinguish between exploration and the process of extracting minerals.

Deductions for capital expenditure on exploration may be carried forward until fully written off: in the case of petroleum such expenditure may be deducted against income from all sources whilst expenditure on mining exploration may only be deducted against income from mining.

The process of securing deductions for allowable capital expenditures incurred in mining operations is more complicated. However, with appropriate care, such expenditures may be deducted under Division 10 or if not fully utilised and the appropriate election made, any excess may be carried forward as a s.80 loss.

(b) Expenditure under Division 10 in relation to mining extends to expenditure on plant used for the treatment of minerals whilst in the case of petroleum the dividing line between allowable and non-allowable expenditure is not entirely clear. It is clear, however, that expenditure on plant used in refining petroleum is not allowable.

(c) Under both Divisions 10 and 10AA the taxpayer may elect, in relation to any unit of plant, that the Division is not to apply; if such an election is made normal depreciation would be claimed.

(d) The investment allowance is available on plant used in the extraction of minerals whether or not the taxpayer makes the election referred to in paragraph (c) above. In contrast, the investment allowance will only be available for plant used in exploration if the taxpayer makes the election. The allowance, of course, is subject to the plant being otherwise eligible under the investment allowance provisions including the requirement that the plant is used by the taxpayer for the purpose of producing assessable income.
However, the investment allowance is not available where a deduction in respect of the relevant expenditure is allowed or allowable under s.124AH (see s.82AM(2)).

(e) Divisions 10 and 10AA extend the deductibility to employee housing and welfare facilities on or adjacent to the site of the extractive operations but any such facilities off the site are not included. On the other hand, expenditure on plant used in mining or petroleum operations is allowable whether or not the plant is physically situated in the mining area.

(f) Division 10AAA allows a deduction for qualifying capital expenditure on facilities involved in the transport of minerals mined in raw and "processed" forms and makes no distinction between petroleum and other minerals.

(g) Expenditure on rolling stock, road vehicles and ships is not included in Division 10AAA as these assets would be eligible for ordinary depreciation and would not come within any of Divisions 10, 10AA or 10AAA.

(h) The investment allowance is not available in respect to expenditure on plant which falls for deduction under Division 10AAA.

The above may assist as a guideline to the available special deductions in the mining industry which will need to be considered in each factual situation with the deductions and other benefits of leveraged leasing in order to determine the most economic result.

7. SOME PROBLEM AREAS

A. Stamp Duty

The potential liability for stamp duty in a leveraged lease transaction can be enormous particularly as some parts of the transaction can be liable to duty in more than one State. The terms of the legislation varies from State to State and except in limited circumstances there is no protection against double duty.

In structuring the lease package advisers must ensure that stamp duty is minimised as far as possible as otherwise any savings in "borrowing" costs to the lessee in utilising leveraged leasing as a technique may well be outweighed by liability to stamp duty.

To illustrate the point, there is a potential liability to stamp duty on the following documents (percentages shown in brackets are the applicable rates of duty in New South Wales at the time of writing this paper).

(1) **The Purchase Agreement** (up to 2.5 per cent) In New South Wales, however, an agreement for the sale of goods wares and merchandise is exempt from duty. A sale agreement may be liable to duty at ad valorem rates if the equipment sold constitutes a fixture to realty.

(2) **Credit or Hiring Duty on the Lease** (1.5 per cent) This could be payable in more than one State particularly in the case of moveables used or located in more than one State.

(3) **Loan Instrument Duty or Loan Transaction Duty** (1.5 per cent) on the loan from lender to lessor. Again this could be incurred in more than one State provided a sufficient territorial nexus is established. The tests are not identical.

(4) **Loan Security Duty** (0.4 per cent) or its equivalent may be payable on the security in one or more States.

If the leased equipment is affixed to land the lessor may require to take a lease (0.35 per cent of total rental) of the land on which the equipment is or is to be constructed or an assignment (up to 2.5 per cent) of any land lease held by the lessee. Any sublease back to the lessee of the site would also attract duty of 0.35 per cent on the total rental. The rental in these arrangements should be nominal.

B. Registration under Bills of Sale or Equivalent Legislation

It will always be necessary to consider whether the lease or the purchase and lease arrangements taken together are registrable as a bill of sale under the applicable State legislation. The New South Wales Companies Act provides for registration under s. 100 of any charge which if given by an individual would be invalid or of limited effect if not filed or registered as a bill of sale under the Bills of Sale Act 1898. Again, this is a most complicated area as the tests are not identical between different States and it is not always clear whether to register as a charge or as a bill of sale or both. There is the added problem of whether the bill of sale is liable to stamp duty.

C. Fixtures

Often there will be a question as to whether or not the equipment is a fixture. If so, title to the equipment vests in the owner of the land to which it is affixed. This gives rise to some problems:

(1) any agreement for the sale of the equipment may be liable to stamp duty;

(2) a question may arise as to whether the equipment qualifies for depreciation under the Income Tax Commissioner's Guidelines; and

(3) how can the lessor's title to the equipment be protected.

In relation to the title question the lessor of the equipment will need to obtain a waiver from the owner of the land and any encumbrancee as to ownership rights and will also need to be guaranteed access rights to inspect and, if necessary, to remove the equipment at any time. The best way to achieve this may be for the lessor to be granted a site lease but, as we have already said, this will involve a potential liability to

stamp duty. In the mining context, it should be remembered that s.107 of the Mining Act 1973 (N.S.W.) prohibits the creation of any interest in an authority granted under that Act (including any lease, licence or other right held in the land) without the consent of the Minister.

D. Powers

It will always be necessary to examine whether the participants in the leveraged lease are empowered to enter into the arrangements and to perform their respective obligations. The lessor may previously have given security over its assets and undertaking which may prevent the creation of the security in favour of the lender. This is often a problem with finance companies which have raised public borrowings under a debenture trust deed. There may also be a question as to whether lenders, particularly life companies, trustee companies and other statutory authorities, have power to lend on a non-recourse basis or to take security of the rather unusual nature involved in a leveraged lease. Banks have their own special requirements and obligations which must be given careful consideration.

8. SOME SUGGESTIONS

The packager in a leveraged lease transaction has an extremely difficult task in marrying the requirements of all the participants. He first approaches the lessee and having gained an acceptance the packager then proceeds to arrange for the necessary funds from both the lessor and lender. The objective is to ensure that the offering memoranda to each of the three groups and the acceptance of those memoranda match up.

There could be some advantage if the offering memoranda and their acceptance could be reduced to a general memorandum signed by each of the participants prior to the commencement of documentation. It would also be desirable if the exact method and manner of participation of each party, their special requirements and the structuring of the total transaction could be agreed upon at this stage. A decision at this time should also be taken as to any necessary arrangements to minimise stamp duty. The powers of the parties and any other general problems of the type we have described should then be analysed and covered. In this way, at the time of commitment in principle by the participants and prior to the commencement of documentation many of the main problem areas should have been resolved.

A further problem area is, we believe, the proliferation of legal representation. Traditionally, the documentation is prepared by the packager's lawyers. The packager normally bears all legal costs associated with such documentation or has included such costs in its fee quote. The lessee bears its own costs but, as distinct from other borrowing arrangements, the lender and the lessor often pay their own costs of any independent legal representation.

The lawyers documenting the arrangement for the packager may be reluctant to accept the responsibility for providing an opinion certificate or comfort letter to other parties from whom they have no specific instructions and who are not responsible for their fees. As a consequence, the lessor and the lender will look to their own lawyers for an opinion certificate. All such lawyers will need to fully and thoroughly examine the whole transaction. This leads to some duplication on the part of the various lawyers and usually involves an increase in the overall legal costs.

In an attempt to reduce the time and cost involved in processing leveraged

lease transactions we suggest that documentation might proceed along the following lines:

(1) Lawyers acting for the packager will attend to all necessary drafting and will assist the packager in matching the requirements of the various parties. They have no responsibility to lender or lessor.
As part of their responsibility to the packager, they will also carry out the necessary searches and investigations as to the corporate powers of the lessee and the other parties and will supply to the packager a certificate in respect of all such matters.

(2) The American practice as we understand it is that one lawyer represents all lessors and another lawyer represents all lenders.

(3) The responsibility of the lawyer representing the lessors might be to review all the documents on behalf of the lessors but without necessarily undertaking an overriding responsibility for all aspects of the transaction.

(4) The lenders' lawyers would review the documentation on behalf of the lenders and certify security in the normal way.

Whilst we have attempted to provide a broad view of leveraged leasing and some implications of its use in the mining industry it will be up to the expertise and ingenuity of members of the finance industry and the mining industry to adopt its peculiar characteristics. We have endeavoured to cover the principal matters governing leveraged leasing so far as the law presently applies and is understood to apply at this time.

There will be changes in procedures and changes in views as the adaptation of leveraged leasing becomes more sophisticated and better known. We believe that the most significant changes will occur and continue to occur in the tax and security areas and draftsmen and users might be well advised to keep this in mind.