Financial leasing

of movable property

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Leasingutredningen

Final report of the Leasing Commission

Summary

The Leasing Commission has been asked to investigate issues relating to the leasing of movable and immovable property. This report concludes the Commission's work. In November 1991, a partial report was presented, which discussed mainly so called sale and lease back of immovable property (Property leasing, Sale and lease back, SOU 1991:81). The report now being presented deals primarily with issues relating to civil law, tax law and, to a certain extent, accounting issues in connection with financial leasing of movable property.

The final report consists of two principal sections. The first section (Chapters 2 to 9) contains descriptions and analyses of existing conditions. This includes *partly* concepts, definitions, forms and terms of agreements, development and scope (Chapters 2 and 3), *partly* existing legal premises from the point of view of civil law, accounting and tax law (Chapters 4 to 6), *partly* the advantages and disadvantages from various aspects (Chapter 7) *and partly* the civil law regulations applicable in certain other countries and under the 1988 convention on international financial leasing (chapters 8 and 9). The other principal section (Chapters 10 to 13) gives an account of the considerations and recommendations made by the Commission. In the field of civil law, these considerations have resulted in bills both on financial leasing as between enterprises (Chapter 10) and on consumer leasing (Chapter 11). Having regard to the ongoing work carried out by others concerning accounting and related tax aspects, no recommendations are presented in this area. As regards taxation, however, an outline is given of the measures which may and should be considered when the said ongoing work has been concluded.

This summary deals mainly with the considerations and recommendations of the Commission.

The importance of financial leasing of movable property as between enterprises

Financial leasing is an important form of financing the acquisition of fixed assets both in Sweden and abroad. The leasing activities of Swedish finance companies are estimated to account for about 20% of the financing of investments by industry and commerce. The book value of the leasing (volumes) reported by the finance companies at the end of 1993 totalled about 36 billion Swedish kronor. To this amount should be added the leasing transactions financed by industry itself, the volume of which is estimated to be equivalent to that of the finance companies. The total outstanding leasing volume can be estimated at more than 100 billion Swedish kronor. Financial leasing is of great significance to the Swedish export industry. Nationally it is utilised by enterprises of all sizes as well as by municipalities, government authorities and public utilities. However, domestic leasing is particularly important as a capital source for small and medium-sized enterprises. Financial leasing may represent one of few possibilities for small businesses to establish themselves and obtain financing for necessary investments. The objects of financial leasing are found among all types of movable property of reasonably permanent value, such as ships, aircraft, buildings, turbines, manufacturing machinery, forest and agricultural machinery, paper machinery, construction machinery, trains, underground carriages, lorries, motorcars, telecommunications offices, communication equipment, computers, various kinds of equipment, intangible rights etc.

Considerations of the need for civil law regulation of national financial leasing as between enterprises

Financial leasing typically produces certain advantages and disadvantages as compared with related forms of finance. The advantages to the lessee frequently consist of the possibility to obtain financing, where financing cannot otherwise be had, and to a certain extent of accounting and tax advantages. The disadvantages to the

lessee (and his creditors) are to a great extent defined in terms of civil law and are ultimately based on the absence of clarifying and balanced rules of law for this type of agreement. The advantages to the lessor are found mainly in the tax treatment, in the flexibility of leasing as a form of financing and in the absence of rules of law, as a consequence of which the lessor, for instance, may frequently, without any major restrictions, enforce the terms of contract which he himself has devised. The relative disadvantages to the lessor consist mainly of the risk inherent in the financing of enterprises with poor liquidity and/or solidity, and to a certain extent in the uncertainty implied by the absence of legislation in the event of the validity of the leasing terms being tested in a court of law.

As a consequence of the uncertainty resulting from the absence of legislation on financial leasing, the outcome of legal disputes is difficult to predict as regards for example the equitableness of the terms of an agreement and the treatment of a leasing agreement on the bankruptcy of the lessee. The uncertainty constitutes an inconvenience primarily for the lessee, but may sometimes be of disadvantage to the lessor as well. The absence of leasing legislation must be regarded as being doubtful from a legal rights point of view, especially when considering the fact that in many important leasing issues there is no guiding case law based on decisions of the Supreme Court.

For a long time, the formulation of the type of agreements represented by finance leases has been governed by the standard terms of the finance companies. During the more than thirty years that this form of financing has been established in Sweden, these terms have shown no significant development as regards balance and equitableness. There are still a number of important terms which must be considered unfair as such, if the lessor were to apply them literally. In many matters, for example, the lessor has the sole or arbitrary right of judgement, and leasing agreements often contain terms which are very hard on the lessee, especially as regards the circumstances entitling the lessor to remedies on a breach of contract by the lessee. The fact that the lessor does not always, in the event of a dispute, apply the terms in full, does not mean that the severity of the terms is without significance. In the law of property, it is not considered to be acceptable from a legal policy aspect to abandon one

party to an agreement to the discretion of the other party, especially if the first party is in an inferior position. A party should be able to rely on legally founded powers, and if a stronger party does not usually invoke a severe clause, he should not, in principle, be able to do so against a certain party or in a certain situation. A selective application of a harsh clause in a bankruptcy or other insolvency settlement will be in conflict with general principles of rights in rem. The fact that the lessor in a dispute frequently does not apply the terms literally, does not mean that he does not do so at other times, which may mean that the lessor on most of its leasing stock may obtain performance, which is beyond the acceptable. This is particularly grave when it comes to those items of the agreement which are economically decisive for the lessee, such as the matter of the size of the rental or a variation thereof or the matter of the damages the lessor can claim on a lessee's breach of contract.

Furthermore, the nature of certain matters in a leasing relationship is such that these matters are difficult to settle effectively by contract or to solve by case law. This is typical for example of the parties' rights and duties in a tripartite relationship, which is typical of financial leasing. The matter of protection of real rights as regards leasing agreements cannot be resolved at all by agreement and it is regarded as uncertain whether it can be resolved by case law. Furthermore, it does not seem possible to create, either by agreement or by case law, specially adapted or clarifying rules for financial leasing as a special class of contract.

In my opinion, a regulation in civil law of financial leasing should come about, mainly to reduce the present legal uncertainty and to create a firmer basis for the assessment of the equitableness of leasing terms. In the first instance, legislation should include rules under the law of contract regarding financial leasing as a special class of contract, and it should be otpional in regard to the relationship between the parties. In certain matters, however, mandatory rules in the lessee's favour should be implemented. The issues relating to the treatment of a leasing agreement in the event of the bankruptcy of the lessee and the lessee's legal position as regards real rights should also be clarified through rules which are mandatory in favour of the creditors.

In the final report, I present a *bill on financial leasing*, which contains rules of the said purport. I will describe below the content of the law.

Swedish accession to the 1988 Unidroit Convention

By the 1988 Unidroit Convention on international financial leasing, an attempt has been made to remove certain legal impediments to international leasing transactions (so called cross-border leasing) for the purpose of increasing the international usefulness of leasing. The convention contains primarily uniform material rules, but also certain rules on the choice of law. It is limited to certain fundamental issues which are specific to financial leasing. The basic idea is to separate financial tripartite leasing from the conventional rental agreement, a conditional sale and a credit sale agreement by giving the transaction its own legal "infrastructure". Here, and by the limitations and definitions of the convention, the primary purpose has been that financial leasing should be recognised in as many countries as possible and that the risk of civil law reclassification into some other type of contract should be minimised.

The background and content of the convention are commented in Chapter 9. Apart from purely treaty law provisions, the convention comprises fourteen articles. The first six articles give definitions, rules on the sphere of application and certain general provisions. The following eight articles contain the actual material rules. The whole convention can be contracted out of , if all three parties (the supplier, the lessor and the lessee) agree. If the parties accept the convention, it is mandatory in three matters, but optional in other respects. Rules on the choice of law are provided on such issues as whether the equipment has become a fixture to or incorporated in land and whether public notice is required to protect the lessor against the lessee's creditors. Uniform material rules are provided on the matters of the lessor's freedom from liability in respect of the equipment, the lessor's liability for legal faults, the lessee's duty to take proper care of and return the equipment, the lessee's right to make claims under Sale of Goods law directly against the supplier, the lessee is not being

bound by the lessor's and the supplier's amendments to the supply agreement, the lessee's right to remedies against the lessor in the event of errors and delays in supplying the equipment, the lessor's right to remedies on the lessee's default and the parties' right to dispose of their rights under the leasing agreement. The convention does not apply to consumer leasing, sale and lease back or any form of real property leasing. It is intended for financial tripartite leasing of equipment between enterprises.

The convention has not entered into force when the final report is presented. However, the third ratification required has taken place recently, and the convention is expected to enter into force at the end of 1994 or the beginning of 1995. When the convention enters into force, it will become immediately applicable in three states, namely France, Italy and Nigeria. As and when the convention comes into force, it is expected that several other states will accede to it. At present it is thought that, for example, China and the USA are about to accede.

It appears from the Commission's review of the convention that it does not contain any rules which are unacceptable from a Swedish point of view. The provisions of the convention are consistently well balanced and carefully considered, both in the choice of regulated issues and prescribed solutions. Although the convention naturally contains a balance between different legal systems, it does not deviate greatly from the rules that may be presumed to apply to financial leasing in Sweden. On several issues the convention contains mediating solutions, the aim of which is to achieve as broad accession as possible.

I recommend that Sweden should accede to the Unidroit Convention. The actual implication of my recommendation is that the material rules of the Convention should be included in Swedish law by incorporation and should thus be applicable as Swedish law in the original languages of the Convention, English and French. This will be implemented by means of a new *Act on international financial leasing*. An official Swedish translation will be included as an annexe to this Act.

The Unidroit Convention as a model for Swedish rules of law

The aims and purposes of the Unidroit Convention correspond largely to the reasons which in my opinion justify a Swedish regulation by law of financial leasing. The direction and drafting of the rules of the Convention are also in line with my idea of how a framework of fundamental rules on financial leasing should be designed in circumstances relating to enterprises. The solutions presented by the Convention are well balanced and directed at issues of central importance in this type of agreement. There are important reasons in favour of Swedish leasing transactions not following a different and less predictable set of rules than that which is applied when a Swedish lessor or lessee concludes an agreement with a foreign counterparty. Uniform rules also make it easier for foreign lessors to operate in Sweden, thus promoting competition in the Swedish leasing market.

In the light of what has been said above, among other things, the rules relating to the law of contract, which it is proposed to include for purely Swedish leasing transactions, have been drafted in close conformity with the provisions of the Unidroit Convention.

Bill on financial leasing

Thus, it is proposed in the final report that a new Act on financial leasing (hereafter referred to as the Leasing Act) be enacted. The Leasing Act can be said to have four main chapters, namely (1) Introductory provisions giving rules on the sphere of application, definitions and limitations, (2) rules under the law of contract governing the relationship between the parties, (3) specific rules on the treatment of the leasing agreement in the event of the bankruptcy of the lessee and (4) rules on the protection of the lessee's rights as against third parties. The content of the Leasing Act is summarised below.

Sphere of application

The Leasing Act applies generally to the financial leasing of all

personal property, except site leasehold rights and buildings situated on the land owned by another party. The rules on the protection of the lessee's rights as against third parties, however, refer only to movable property, which does not consist of a registered ship or aircraft. The Leasing Act shall not apply to sale and lease back transactions, consumer leasing or international leasing transactions governed by the bill on international financial leasing. Some analogous application is presumed in respect of the rules relating to the law of contract as well as real rights.

Definition of financial leasing

As in the Unidroit Convention, financial leasing according to the Leasing Act is a tripartite transaction between a supplier, a lessor and a lessee. The lessor acquires the equipment from the supplier in accordance with a supply agreement and grants possession of the equipment to the lessee in accordance with a leasing agreement. The definition in the Leasing Act covers both so called indirect and direct triangular leasing. The definition requires *that* the lessee is granted an opportunity to approve those terms of the supply agreement, which concern its interests, *that* the lessor does not select, specify or supply the equipment and *that* the lessee's financial commitment is calculated so as to cover the whole or a substantial part of the acquisition cost of the equipment.

Leasing agreements with options - borderline to purchase

A leasing agreement - rather than a purchase agreement - exists according to the Leasing Act, even if the lessee has the right or obligation to buy the equipment at a predetermined price, provided that the lessor took a considerable interest in the development of the market value of the equipment in relation to that price when the agreement was concluded. Unless the interest of the lessor was considerable, the law on Sale of Goods shall apply. It is proposed that the same rule shall apply in those cases, where the equipment is to be sold or a sales value is to be determined at the end of the lease term, and where a settlement is to be made against the value of the equipment at the time, as determined in the agreement. These rules

agree in all material aspects with the results of the analysis of existing law made in the final report.

The lessor's right to vary the rental

Where the lessor has reserved the right to vary the rental, it is proposed in the Leasing Act that the lessor shall have the right and the obligation to vary the rental in connection with changes in an offically quoted rate of exchange or rate of interest which has been stated in the leasing agreement. The lessor cannot vary the rental for any other reason, which is not connected with the supply of the equipment or an official action intended to affect the public. If the official quotation is discontinued or if the lessor can show that the reference indicated in the agreement has lost its function in general, the lessor is entitled to change to another officially quoted reference, if it has reserved the right to do so in the agreement. In the event that the change produces a substantial increase in the rental, the lessee shall have the right to buy the equipment at its calculated (mathematical) residual value at the time of the change.

It is further proposed that the lessor shall have the duty to inform the lessee of any decisions to vary the rental and of any change in the rate of exchange or rate of interest. Any notice of a variation shall state the reason for the variation in such a way that the lessee can verify that the variation is in agreement with the terms of the lease. In order to enable such verification, the leasing agreement must state the conditions of a variation and the internal rate of return of the agreement.

The rules on the variation of the rental are proposed to be entirely mandatory in favour of the lessee.

The lessee's liability to pay, the lessor's freedom from liability and the lessee's duty to take proper care

According to the proposal, after the equipment has been delivered, the lessee shall stand the risk of his commitment to pay or of any guarantees made to the lessor and it shall have the same duty to care for the equipment and the same liability as a lessee in general. The lessor shall not, in principle, be liable to the lessee in respect of the

equipment. These rules are proposed to be optional.

The lessor's warranty regarding quiet possession

If the lessee, in excercising its rights under the leasing agreement, is disturbed by someone who has a superior title to the equipment, the lessee shall be entitled to enforce against the lessor the remedies stipulated by the Sale of Goods Act in cases of legal error. This does not apply, however, if the claim to a superior right is based on an act or omission by the lessee. A superior right shall be equal to an allegation of a superior right, if there are reasonable grounds for the allegation. The rules are proposed to be optional.

Rules on the triangular relationship

It is proposed that the rules of the Unidroit Convention on the specific triangular relationship in financial leasing should be included in the Leasing Act without any factual changes. The rules are optional in the Leasing Act, just as they are in the Convention. To begin with, they imply that the supplier's duties under the supply agreement shall be owed also to the lessee, as if it were a party to the supply agreement and as if the equipment had been supplied directly to the lessee. However, the lessee shall not be entitled to cancel the supply agreement without the consent of the lessor. This regulation implies, among other things, that if the lessee has suffered a loss as a result of faulty equipment or a delay in delivery, it can claim damages from the supplier.

It is further proposed that, if the equipment is faulty or there is a delay in delivery, the lessee shall have the right as against the lessor to reject the equipment or terminate the agreement, in the event that the supply agreement between the lessor and the supplier had entitled the lessee to do so, if it had bought the equipment from the lessor on the terms of the supply agreement. The lessee shall be entitled to withhold rentals payable until the breach of contract has been remedied. By contrast, the lessee shall not be entitled to require the lessor to remedy faults, supply new equipment or pay damages. This regulation implies, among other things, that the lessor will stand a certain risk in the event of the supplier's insolvency.

Finally, this chapter provides a rule as to how the lessee will be affected by variations of the supply agreement made by the supplier and the lessor. The rule means that the lessee shall not be bound by such variations, if they refer to terms previously approved by the lessee.

The lessor's right to remedies on the lessee's default

Under the Leasing Act, any default by the lessee entitles the lessor to demand performance and, as the case may be, interest on accrued unpaid rentals. Where the default is substantial, and where the lessor by notice has given the lessee a reasonable opportunity to remedy its failure, the lessor is further entitled to choose either to require accelerated payment of future rentals, if the leasing agreement so provides, or to terminate the agreement, recover possession of the equipment and claim such damages as will place the lessor in the position in which it would have been, if the leasing agreement had been performed in accordance with its terms (the "positive contractual interest"). The lessor shall not be entitled to recover damages for a loss, which it has not taken reasonable steps to mitigate by selling the equipment, in the first place, or leasing it to another party. It is proposed that these rules shall be optional with two exceptions. The implication of the first one is that the lessor, upon termination of the agreement, cannot invoke a proviso regarding accelerated payment. The second exception refers to the validity of damages clauses, which shall not apply, if they should result in damages significantly exceeding the "positive contractual interest". The regulation agrees in all material aspects with the stipulations of the Unidroit Convention.

The lessor's right of termination upon an anticipated breach of contract by the lessee

The Leasing Act further proposes a special provision regarding an anticipated breach of contract on the part of the lessee. Thus if it is evident that the lessee's breach will be substantial, the lessor shall be entitled to terminate the leasing agreement, even before the breach of contract is a *fait accompli*. However, the lessee can neutralise the termination by providing, without delay, acceptable security for its

performance. The stipulation has been drafted in close conformity with Section 62 of the Sale of Goods Act and has no counterpart in the Unidroit Convention.

Transfer of rights under the leasing agreement

In accordance with the general principles of the law of contract, the lessor shall be entitled, according to the Leasing Act, to transfer or otherwise dispose of its rights under the leasing agreement or its right to the equipment, without thereby being relieved of its duties to the lessee. By contrast, the lessee, as a principal rule, may not dispose of its rights except with the consent of the lessor. If there is no justification for assuming that the lessee's disposal should jeopardise the lessor's right to the equipment, the lessee shall, however, be entitled to complete the disposal, for example a sub-lease, even if the lessor does not consent. The lessee is liable for its duties under the leasing agreement after the disposal, unless otherwise agreed with the lessor.

The rules on the right of disposal are optional in the relationship between the parties. By contrast, any term of the agreement limiting the right of transfer shall not be enforcable in a transfer by compulsory auction or the bankruptcy of one party, i.e. in relation to the creditors of either party.

The lessee's bankruptcy

The proposed Leasing Act also contains rules on the treatment of the leasing agreement on the bankruptcy of the lessee. In conformity with the rules on a purchase or leasing of premises, the lessee's estate in bankruptcy is entitled to replace the lessee as a party to the leasing agreement, while the lessor is entitled to ask the estate whether it wishes to enter into the agreement and to receive a reply within a reasonable period of time. If the estate exercises its right, it becomes a party to the agreement and the lessor's claims become claims against the estate as such in respect of the period after the receiving order. Even if the bankruptcy estate does not enter into the agreement, it is proposed that the estate should pay the rentals under the leasing agreement for any period during which the estate uses the equipment.

Should the bankruptcy estate decide not to become a party to the leasing agreement, the lessor shall be entitled to terminate the agreement, recover possession of the equipment and claim damages from the bankruptcy estate at a maximum amount corresponding to the actual loss calculated according to the "positive contractual interest".

The proposed rules do not entitle the lessor to require the estate to provide special security beyond the security resulting from the claim against the bankruptcy estate itself. The reason for this is that the lessor normally has already a certain security because of the lessor's right of repossession of the equipment in a bankruptcy, and because rentals are as a rule paid in advance for each period. In the event that a substantial default by the estate can be anticipated, the lessor may terminate the agreement on this ground and recover possession of the equipment, unless the bankruptcy estate is able to avert the termination by providing acceptable security without delay.

In line with the regulation in the exposure draft of the Council on Legislation regarding the Corporate Restructuring Act, which is expected to be presented shortly, a rule has been included in the Leasing Act, which limits the lessor's right to terminate the leasing agreement on the bankruptcy of the lessee on the ground of default by the lessee prior to the bankruptcy.

All of the rules on the lessee's bankruptcy are proposed to be mandatory in favour of the bankruptcy estate.

Protection of the lessee´s rights as against third parties

The Leasing Act concludes with rules on the protection of the lessee's rights in financial leasing of movable property. The regulation implies that the lessee's right under the leasing agreement (the leasing right) is protected in the same way as established rights in rem, such as ownership and lien. As a result, the lessee's possession of the equipment gives it unconditional priority over subsequent acquirers of ownership of or lien on the equipment. Even if the lessee has not taken possession of the equipment, the leasing right is superior to a rival claim under a right in rem, unless the possessor of the equipment has received it in good faith with regard to the leasing right. It is further proposed that a bona fide acquisition of a leasing right should

be possible in accordance with the Act on bona fide acquisition of personal property.

As regards the lessee's protection against the lessor's creditors, the proposed rules are based on the same principles as apply to the leases of real property. The regulation implies that the lessee has no protection, unless it has taken possession of the equipment. If the lessee has taken possession, it has unconditional protection against all creditors, except the holder of a lien, who according to the legal rules on preference has a right superior to the leasing right. If the equipment is encumbered with such a lien, the leasing right may be lost, where the equipment is sold on distress or bankruptcy, if a sale subject to the leasing right results in the pledgee's receiving substantially less for his claim. However, the lessee may preserve its right in this case by compensating the pledgee for his loss resulting from the remaining in force of the leasing agreement. When applying these rules, the pledgee shall be entitled to take into account payments received under the leasing agreement, which refer to the period following the distress order or adjudication order in bankruptcy.

A notice to a third party, who is in possession of the equipment is consistently treated as being equal to a transfer of possession.

Consumer leasing

Considerations

Large parts of the terms of an ordinary agreement on financial leasing must be regarded as inequitable in a consumer relationship. The presentation and marketing of this type of agreement, which have been known so far, are unacceptable in a consumer relationship. The types of consumer leasing, which have been applied in recent years, have resulted in big problems and perceptible losses to a relatively large number of consumers. This is particularly true of the car leases which were concluded in the years from 1986 to 1990, when the requirement for a minimum down payment in a credit sale was particularly high. There are no guarantees that similar problems will not arise again.

The review of the advantages and disadvantages of consumer

leasing, which the Commission has performed, shows that the only circumstance which may be an advantage of consumer leasing from the individual consumer's point of view is that he may avoid or obtain a lower down payment than in the case of a credit sale. However, this cannot, of course, be seen as an advantage from the point of view of consumer protection. It shows instead that the primary function of financial consumer leasing is to circumvent the mandatory rules of protection contained in the Consumer Credit Act. The list of the disadvantages of financial consumer leasing could be made long.

Particularly after the Consumer Credit Act was given a wider scope in 1992, so as to apply, in principle, to all other forms of consumer credit, the absence of the corresponding rules for financial leasing seems to constitute an inconsistent and unwarranted gap in consumer protection.

Without comparison, the most common and, to the consumer, the financially most important form of consumer leasing refers to private cars. From the consumer's point of view, the agreements here are virtually identical with a credit sale. This is only natural, since financial leasing does not provide any advantage worth mentioning for the individual consumer, except the possibly short-term advantage of being able to circumvent the down payment.

Proposals

In the light of what has been said above, I recommend in the final report that *the mandatory rules on credit sales contained in the Consumer Credit Act* should be applied equally to financial consumer leasing, with certain deviations and clarifications regarding the special circumstances of leasing. Among the rules on credit sales, which shall be applied to consumer leasing, are the provisions on a minimum down payment, the right of consumers and creditors to require accelerated payment and the rules on the creditor's right of repossession and the settlement to be made then. As regards the variation of the rental and the protection of the lessee's real rights, I recommend that *the rules of the Leasing Act* should apply to consumer leasing as well.

Special rules on consumer leasing are proposed for the triangular

relationship, which is characteristic of this type of agreement. According to these rules, the lessee shall be entitled to make claims under the Consumer Sales Act against the supplier of the goods, as if the supplier had transferred the goods directly to the lessee. As against the lessor, the lessee is entitled to enforce its rights according to the rules of the Consumer Credit Act on triangular relationships, where the lessor shall be regarded as a creditor. The same rules are proposed to apply to both indirect and direct triangular leasing.

It shall further be obligatory in consumer leasing, as in consumer credit sales, in marketing and prior to the conclusion of agreements, to provide information on the effective rate of interest, the cost of credit and the cash price. Information shall also be provided about the lessee's total financial commitment and the fact that no part of the rental may be deducted for tax purposes. All prices and amounts shall be stated, including value added tax.

Finally, the lessee shall be entitled to terminate the leasing agreement at any time prior to expiry and to return the goods, although not before one year of the lease term has passed. Here, the rules of the Consumer Credit Act regarding settlement on repossession shall apply. The lessee must give one month's notice.

Amendments to the Sale of Personal Property Act

In order to eliminate an existing uncertainty regarding the possibility to carry out sale and lease back transactions involving aircraft, which are valid from a real rights point of view, it is proposed to amend the Sale of Personal Property Act to mark more clearly that this Act covers such property as well. At the same time certain simplifications and enhancements of the sale of personal property are proposed. Thus there is no longer a requirement for a deed of sale to be signed by witnesses, for the document to be presented to the head of the relevant enforcement district, or for the special thirty days of grace for a subsequent bankruptcy, distress or floating charge.

Tax and accounting issues

Background

Swedish tax legislation does not provide any specific rules on the leasing of movable property. The tax consequences of a leasing agreement are determined on the basis of general tax rules and general principles of tax law. There is no distinction between finance leases and operating leases. As a rule, leasing agreements are treated as rental agreements, which means, among other things, that the lessor is entitled to depreciation allowances, while the lessee will be entitled to deduct the whole of the rentals if the lessee is an enterprise.

Agreements which have been denoted leasing agreements may sometimes constitute purchases. When determining the matter of transfer of ownership, the tax treatment is usually also based on a consideration of the civil law relationship between the parties.

There are also strong links between tax law and the accounting treatment. Today leasing agreements are accounted for without distinguishing between operating and finance leases. With few exceptions, the parties treat these agreements as operating leases. This means for example that the lessor includes the asset in its balance sheet and that the lessee does not account for its obligation to pay rentals as a liability.

In June of this year, the Swedish Accounting Standards Council (Redovisningsrådet) adopted a draft recommendation on the accounting treatment of leasing agreements. The implication of the draft is that leasing agreements should be accounted for in accordance with international practice, IAS 17 (the International Accounting Standards Committee's recommendation number 17, Accounting for Leases). IAS 17 is based on a financial approach often defined as "substance over form". This means that the accounting treatment of the transaction is determined by the financial implication of the transaction rather than its legal form in civil law. IAS 17 classifies leasing agreements as either operating leases or finance leases, which is of vital importance to the accounting treament. Under a finance lease substantially all the rewards and risks relating to ownership are transferred to the lessee. Thus the lessee accounts for the lease as an

asset, the obligation to pay future rentals shall be accounted for as a liability and it is the lessee who is entitled to depreciate the asset.

Effects of financial leasing

The Commission has analysed to what extent the actions of the parties are influenced by the intent of obtaining tax advantages or undue benefits under various rules in this area.

It has been said that the leasing of movable property does not generally produce any tax advantage, since the lessee rather than the lessor would have been entitled to depreciation allowances, if the lessee had opted to buy the property. Such a line of reasoning presumes, however, that the enterprises concerned are in the same tax position. Yet, different companies incur different tax expenses on the acquisition of an asset. In one enterprise, the tax reduced by an allowance does not always equal the corresponding tax increase in the other enterprise. The value of depreciation for tax purposes is not the same in each enterprise. This has had an impact, particularly on investor leasing.

The tax advantages of leasing are often linked to the situation of the individual enterprise, but certain general tax advantages can be demonstrated. It may be of advantage to the lessee not to be dependent on the size of the depreciation charges. Where short lease terms are involved, it can deduct for costs more quickly by deducting rentals than by depreciation. Where movable property is added to the lessee's immovable property by leasing, the added property does not normally change its nature for tax purposes, but still constitutes equipment in the lessor's accounts. This is an advantage, if the property is of a kind which, if it had been bought by the lessee, would have been depreciated according to the rules for buildings or land improvements, for which the depreciation period is considerably longer than for equipment. By deducting for rentals instead of depreciation, the lessee can achieve significantly faster cost deduction. The permissible depreciation of leased assets is usually larger than the actual depreciation at the beginning of the lease term. Consequently the lessor can allocate the income from rentals and the depreciation charges over the lease term in an advantageous way.

In investor leasing, the investor obtains a depreciation base and depreciation charges reduce the taxable income. The fact that the depreciation charges initially, as a rule, are considerably larger than the rental income, enables the investor to set off a deficit in the leasing business against a profit in another business. It is not unusual for the investor to finance the acquisition by means of funds borrowed from the intermediary and even the interest on the loans is of course deductible. If the leasing business is carried on in a partnership, a certain allocation of income or loss can be made for tax purposes as between the partners of the partnership (investor company). By means of group contributions, the loss of the partnership can then be transferred within a wholly owned group through an owner which is a limited company, thus achieving considerable tax advantages. The tax effects have resulted in the establishment of leasing businesses purely for tax reasons. Since the tax reform, the volume of investor leasing has decreased considerably, since for example the lower corporate tax has reduced the value of depreciation and loss. However, investor leasing is still very important when it comes to property for which the cost of investment totals very large amounts and where the useful life of the asset may be 15 to 20 years or longer.

The general possibility to depreciate even equipment acquired on 31 December by 30 per cent of the acquisition value, increases interest in dealing in depreciation bases immediately before the end of the fiscal year, which has happened for instance in investor leasing and sale and lease back. In sale and lease back transactions it is not unusual for accounting aspects to be of decisive importance.

A large number of financial leases contain provisions on a guaranteed residual value, provisions to the effect that the lessee alone or together with the lessor shall benefit from the positive difference between the market value of the asset at the end of the lease term and the estimated residual value, provisions on the lessee's right or duty to acquire the asset at a certain price at the end of the lease term, etc. In some cases the implications of the terms of the leases render the leases comparable to a purchase, although the parties normally seem to assume that the leases will be taxed as rent. It seems to be reasonable to assume that this development in the drafting of agreements has been influenced by the fact that the parties perceive

it as a tax advantage, if an agreement which is comparable to a purchase is taxed as rent.

A market has also developed for international leasing, cross-border leasing. This form of leasing, where at least one party is resident in a country different from that of the others, is an important and accepted form of cross-border investment. However, it often seems that the structuring of leasing agreements has been significantly influenced by the possibilities to obtain tax advantages. The legislative differences of the countries involved are then used in the formulation of the agreements, for example by making it possible to depreciate the same asset in several countries, a so called double dip, triple dip etc.

According to the principal rule, there is no right to deduction for VAT paid, when purchasing a private car. The purpose of this is to levy VAT at a standard rate for the private use of a car. By contrast there is full right to deduction for all the VAT paid for the costs of running the car. If a car is leased, a standard deduction of half of the VAT paid on the rentals is permitted. The purpose of the rule on a standard rate in regard to leases is to compensate in terms of VAT for the running and financing costs which may be included in the rental. From a VAT point of view, there should in principle be no difference between the purchase and leasing of a private car. However, there is no difference between different forms of leasing as regards the right to deduction at a standard rate. A deduction may be made for 50 per cent of the VAT on rentals, even if the lessee, under the agreement is fully responsible for the running costs and consequently has the full right to deduct for the VAT paid on these costs. Thus there is regular overcompensation for the running costs in connection with financial leasing.

Considerations

Generally speaking it may be seen as a good thing that the market is able to offer various forms of financing in order to satisfy the demand for equipment etc. The forms of agreement and alternative financing, which are being developed, should not, however, have as their principal or only purpose to avoid tax or obtain tax credits. Financial leasing may typically be seen to imply certain tax advantages. Leasing

businesses have been known to have been established purely for tax reasons, especially through investor leasing, before the tax reform, as well as through other leasing by the establishment of limited partnerships (kommanditbolag). Yet, it cannot be maintained that the various rules in this area have been unduly exploited. The fact is rather that the existing rules on depreciation of equipment and a formal view of the distinction for tax purposes between a purchase and a lease have been used as far as possible. Consequently the Commission has particularly examined the steps that may be considered in this respect. Regardless whether tax advantages can be achieved or not, these considerations should be seen against the background of the uncertainty prevailing about the legal position in some respects. This is true particularly for the distinction between a purchase and a lease, but also in regard to the question whether a requirement to deliver is valid as a prerequisite for the acquirer's right to depreciate equipment and the implications of such a requirement to deliver.

The main purpose of the Swedish Financial Accounting Standards Council is to develop the accounting standards, which apply to certain large, so called public companies, for example by issuing recommendations. As has been said before, the Financial Accounting Standards Council has adopted a draft recommendation on the accounting for leases, which corresponds in all material aspects to the international standard, IAS 17. However, the draft differs from IAS 17 in as much as it is permitted for a group and an individual legal entity to apply different accounting principles. An application in full of the rules on accounting for leases by a legal entity has been regarded as not being practically feasible in every case, since specific rules on taxation on the basis of such accounting either do not exist or are incomplete.

The Accounting Law Committee (Ju 1991:07) was asked, among other things, to analyse whether there is reason to reconsider the link which exists between accounting and taxation in Sweden.

Having regard to the work thus being performed in various quarters, I will not make any suggestions in the fields of accounting or taxation. It is my opinion, however, that an adjustment of the Swedish accounting rules to IAS 17 should be aimed at. Certain tax law

measures should also be considered regarding the distinction between a purchase and a lease, the delivery requirement in respect of equipment and the use of the standard VAT rate for the leasing of private cars.

I recommend that the civil law distinction between a purchase and a lease of equipment should for the time being form the basis of the distinction for tax purposes. Reasonable taxation presumes, however, that the financial implications of leases are taken into account in the tax treatment, since they may differ considerably from the formal assessment of the leases.

The purpose behind the rules on depreciation as recorded in the books and their favourable nature also constitute good reasons for applying a financial approach to the question as to which one of the parties to a lease should enjoy the right to deductions for the depreciation of equipment. Such an approach should be adopted, in as much as leases, which have such strong features of the sale of goods and credit law that, in reality, they have the same effect as a purchase, should also be treated according to this effect for tax purposes. Leases containing terms, which, at the inception of the lease term, result in the lessor's interest in the value of the equipment at the expiry of the lease term being so insignificant that no actual financial ownership interest remains, should be taxed as purchases. When assessing the allocation of the rewards and risks between the parties, such circumstances as the length of the lease term, the existence of options to buy or sell, the right or duty to renew the lease and the nature of the equipment and its estimated value must be accorded particular importance.

However, the Commission does not have sufficient supporting material, for example from a socio-economic and a legal policy point of view to enable it to form an opinion on the appropriateness of a general transition to a purely financial approach. Consequently, such rules are not recommended, even if it would be reasonable to do so strictly from a tax point of view. Nor can it be determined at present whether such a transition should be implemented by means of special tax rules or by linking it to a possible accounting classification of financial leases. Yet, the appropriateness of a general transition should be considered, when the work relating to accounting issues, which is

being carried on in various quarters, has been concluded.

The Commission further recommends that a delivery requirement as a prerequisite for the acquirer's right to deduct for the depreciation of equipment should be explicitly codified and that this requirement should, for the time being, be maintained also in the sale and lease back of equipment. A codified delivery requirement means that the buyer is entitled to depreciate the equipment, provided that he is regarded as the owner of the assets for tax purposes and that they are in the possession of the buyer or a third party for the buyer's account or that they have been delivered by the seller for transportation to the buyer. If the equipment is already in the possession of a third party at the time of the lease, as for example in investor leasing, a notice terminating the right of disposal may replace physical delivery.

As regards the rules relating to VAT law, it is recommended that the deduction at a standard rate in respect of private cars and motorcycles should be abolished, in so far as they refer to leases, under which rentals do not include running costs. With the present rules there is regular overcompensation of running costs in connection with financial leasing. This form of hire consequently receives a more favourable tax treatment than a purchase. However, it is better to await the continued work on the VAT directives within the EU.

Credit law issues

Financial leasing constitutes financing business according to the Credit Market Companies Act (1992:1610). Such business may, with certain specially stated exceptions, be conducted only by permission of the Financial Supervisory Authority (Finansinspektionen). In recent years, leasing businesses have been established by Swedish partnerships (handelsbolag) and limited partnerships (kommanditbolag) for tax reasons. As far as may be seen from the Commission's material, these partnerships should have been under an obligation to obtain a permission, but have not done so. The Commission can only draw the Financial Supervisory Authority's attention to that which has come to the knowledge of the Commission.

Regeringskansliets Offsetcentral 1994