

Leased Plant and Machinery

Technical Note

1 August 2006

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1 INTRODUCTION

The legislation

- 1.1 The legislation for identifying and taxing long funding leases of plant or machinery is contained in Schedules 8 and 9 of the Finance Act 2006.
- 1.2 Part 1 of Schedule 8 amends the Capital Allowances Act 2001 ("CAA") to introduce the definition of a long funding lease and to enable capital allowances to be claimed by long funding lessees. It also includes machinery provisions concerned with the transfer of leases, extensions of lease terms and various anti-avoidance provisions.
- 1.3 Part 2 of Schedule 8 introduces sections 502A to 502L into the Income and Corporation Taxes Act 1988 ("ICTA") to bring in the non capital allowance aspects of the new regime for companies.
- 1.4 Part 3 of Schedule 8 introduces sections 148A to 148J into the Income Tax (Trading and Other Income) Act 2005 ("ITTOIA"). These sections apply for income tax in a similar way to the sections introduced by Part 2 into ICTA for corporation tax.
- 1.5 Part 4 of Schedule 8 deals with the commencement and transitional provisions.
- 1.6 Schedule 9 covers –
 - minor changes to legislation in s.494AA (petroleum extraction activities: sale and leaseback), s.501A ICTA (supplementary charge in respect of ring fence trades) and s.782 ICTA (leased assets: special cases),
 - the chargeable gains aspects of the new regime,
 - a small change to Schedule 12 FA 1997 (leasing arrangements: finance leases and loans),
 - leasing to tonnage tax companies,
 - withdrawal of first year allowances for lessors of certain plant or machinery,
 - changes to the rules in s.67 CAA (hire purchase and similar transactions),
 - the phasing out of the overseas leasing rules,
 - a small change to s.219 CAA (the meaning of "finance lease" for the purpose of the anti-avoidance provisions in Chapter 17 of Part 2 CAA),
 - changes to the allocation rules in s.220 CAA.

This Technical Note

- 1.7 This Technical Note covers three topics:
 - The main body of the Note replaces, updates and expands on the guidance given in previous Technical Notes. As a consequence, some previous material is reproduced here for convenience.

- Annex A contains a draft of the Regulations that will be made in the autumn on the definition of background plant or machinery.
 - Annex B contains a draft of the Regulations that will be made in the autumn on the rules allowing lessors to elect into the new regime, together with a draft of associated guidance.
- 1.8 Further guidance, including a new leasing manual, will be published as soon as practicable.
- 1.9 Comments are invited on the draft Regulations. Comments should be received by 29 September 2006.
- 1.10 This Technical Note will be used as the basis for producing further guidance and so comments on any errors or ambiguities will be welcomed. Comments before 29 September would be appreciated, but may be made later.
- 1.11 All comments should be addressed to the contact point named at the end of this Technical Note.

2 LONG FUNDING LEASES

Definition of a long funding lease (s.70G CAA)

- 2.1 A long funding lease is a plant or machinery lease (paragraph 2.9) that is a funding lease (paragraph 2.13) which is not –
- a short lease (paragraph 2.31),
 - an excluded lease of background plant or machinery for a building (paragraph 2.72),
 - excluded because it is a lease of plant with land and the plant has a low percentage value (paragraph 2.81).
- 2.2 These conditions apply equally to lessors and lessees.
- 2.3 The tests for a long funding lease are carried out independently by lessors and lessees. Therefore a lease may be a long funding lease for a lessor, and not a long funding lease for the corresponding lessee. There are, however, rules to prevent two claims to capital allowances on the same asset which mean that where a lessor can claim capital allowances because the lease is not a long funding lease, it cannot be a long funding lease for the lessee.
- 2.4 There are special rules where the lease is of a qualifying ship to a tonnage tax company (see part 10 of this Note).
- 2.5 Exclusions from the definition of a funding lease are described in paragraph 2.26.

Rules applying to lessees

- 2.6 In the case of a lessee, a lease is not a long funding lease where the lessor has the right to claim capital allowances, or would do if it were within the charge to tax (paragraph 4.44).
- 2.7 A lessee cannot treat a lease as a long funding lease unless it makes a return for the period covering the inception of the lease on the basis that the lease should be taxed as a long funding lease (s.70H(1) CAA).
- 2.8 A lessee cannot make a claim for relief under the error or mistake relief provisions on the grounds that a return that shows that a lease should be taxed as a long funding lease or not was made in error or by mistake (s.70H(2) CAA).

Plant or machinery lease (s.70K CAA)

- 2.9 A plant or machinery lease is –
- an agreement or arrangement
 - (a) under which a lessor grants another person the right to use the plant or machinery for a period of time, and
 - (b) which is treated under generally accepted accounting practice as a lease;

- an agreement or arrangement which is treated under generally accepted accounting practice as a lease and conveys or would convey the right to use an asset which is plant or machinery;
 - the finance lease element of a sale and finance leaseback of plant or machinery.
- 2.10 A lease is treated under generally accepted accounting practice as a lease if it is accounted for as a lease under SSAP 21, IAS 17 or IFRIC 4. A lease is not treated as a lease if, for example, it is accounted for as –
- a financial transaction under IAS 39, or
 - a service concession (for UK GAAP, FRS 5, Application Note B; for IAS, IFRIC draft interpretation D12).
- 2.11 If a lease satisfies the conditions for being a plant or machinery lease immediately after the commencement it is treated it as a plant or machinery lease from its inception (s.70K(5)).
- 2.12 The term "plant or machinery" has the same meaning as it has elsewhere in CAA. That is to say, it is largely undefined except for the general provisions at sections 21 to 24 and various specific provisions within Part 2 of CAA.

Funding leases (s.70J CAA)

- 2.13 A funding lease is a plant or machinery lease that satisfies at least one of these conditions at its inception –
- it is or will be accounted for as a finance lease or loan (the finance lease test, s.70N CAA);
 - the present value of the minimum lease payments is equal to or more than 80 per cent of the fair value of the asset (the lease payments test, s.70O CAA);
 - the term of the lease is more than 65 per cent of the remaining useful economic life of the asset (the useful economic life test, s.70P CAA).

Finance lease test (s.70N CAA)

- 2.14 The finance lease test is met if, under generally accepted accounting practice, the lease is or should be accounted for as a finance lease or loan in the accounts of the person taking the decision. In the case of a lessor, it is also a funding lease where it is or should be accounted for as a finance lease or loan in the accounts of anyone connected with the lessor, including in the consolidated accounts.
- 2.15 Section 50 FA 2004 means that –
- where accounts are prepared under UK GAAP, then it is UK standards that are applied, and
 - where the accounts are prepared under international accounting standards, it is those standards that are applied.
- 2.16 If the person is not within the charge to tax and accounts are not prepared in accordance with international accounting standards or UK GAAP then international accounting standards should be used (s.70N(3) CAA).

Lease payments test (s.700 CAA)

- 2.17 The lease payments test is met when the present value of the minimum lease payments is equal to or more than 80 per cent of the fair value of the asset.
- 2.18 The minimum lease payments (s.70YE CAA) are the minimum payments over the term of the lease, including any initial payment, together with –
- in the case of a lessee – any residual amount guaranteed by the lessee or anyone connected with the lessee
 - in the case of a lessor – any residual amount guaranteed by the lessee or a person not connected with the lessor.
- 2.19 In calculating the minimum lease payments, the part of any payment that represents charges for services or qualifying UK or foreign tax should be ignored. Qualifying UK or foreign tax is any tax apart from income tax or corporation tax or the overseas equivalent.
- 2.20 The residual amount is so much of the fair value of the asset as cannot reasonably be expected to be recovered by the lessor from the payments under the lease.
- 2.21 The fair value of an asset is its market value (paragraph 2.58) less any grants receivable towards its purchase or use.
- 2.22 Example Alan leases an asset to Betty. The market value of the asset is £1 million and Alan received a grant of £150,000 towards its purchase. That makes the fair value of the asset £850,000. If the payments under the lease could be expected to recover £800,000 the residual amount is £50,000.
- 2.23 The present value of the minimum lease payments is calculated by using the interest rate implicit in the lease, which is the interest rate that would apply in accordance with normal commercial criteria, including generally accepted accounting practice. Exceptionally, where the interest rate cannot be determined (as may happen in the case of some operating leases) the interest rate implicit in the lease is the temporal discount rate given by s.70 FA 05.

The useful economic life test (s.70P CAA)

- 2.24 The useful economic life test is met if the term of the lease (paragraph 2.47) is more than 65 per cent of the remaining useful economic life of the asset.
- 2.25 The remaining useful economic life is the period –
- beginning with the commencement of the term of the lease, and
 - ending when the asset is no longer used, and no longer likely to be used, by any person for any purpose as a fixed asset of a business (s.70YI CAA).

Exclusions from definition of funding lease (s.70J(3)-(6) CAA)

2.26 A lease is not a funding lease if –

- it is a hire purchase or lease purchase contract to which s.67 CAA applies (s.70J(3)).
- the plant or machinery has previously been leased out by the current owner, where none of the previous leases was a funding lease and the aggregate of the terms of the previous leases was more than 65 per cent of the useful economic life of the asset when first leased out (s.70J(4) and (5)).

2.27 In addition, in the case of a lessor, a lease is not a funding lease if –

- the plant or machinery was leased for at least 10 years before 1 April 2006, and
- the lessor under the plant and machinery lease was also the lessor of the plant or machinery on the last day before 1 April 2006 when the plant or machinery was leased (s.70J(6))

2.28 Example Barsetshire Bank leased an aircraft to Sunandseas Airways on a 6-year lease that ended on 30 April 2000 and the same aircraft was leased to Sunnyseas Airways from 1 June 2000 to 31 May 2006. When that lease ended Barsetshire Bank granted Snowandice Airways a 10-year lease beginning on 1 May 2006. The new 10-year lease is not a long funding lease because the aircraft had been leased for 12 years before 1 April 2006 and Barsetshire Bank was the lessor of the aircraft on the last day before 1 April 2006 on which it was leased (here, 31 March 2006).

2.29 Capital expenditure may be incurred on updating or improving an asset that has been subject to a lease for 10 years before 1 April 2006. In considering whether this capital expenditure is covered by s.70J(6) the item of plant or machinery should be looked at as a whole, rather than as a set of component parts. Therefore, as long as the expenditure is not on, or does not create, a separate asset then s.70J(6) will apply if the plant or machinery as a whole has been leased out for 10 years before 1 April 2006.

2.30 Example Rosco Plc leased a train to Broad Street Railways for 12 years ending on 30 April 2006. By 30 April 2006, the train was in need of updating. Therefore Broad Street Railways approached Rosco Plc, asking it to improve the train by replacing the engines and introducing safety equipment. Rosco Plc agreed to fund the improvements. The train was leased again to Broad Street Railways under a lease from 1 May 2006. The improvements were paid for by Rosco Plc and reflected in the rentals.

For the purpose of s.70J(6) the plant or machinery is the train, and the lease that commenced on 1 May 2006 is not a funding lease.

Short leases (s.70I CAA)

- 2.31 A short lease is –
- a lease whose term is not more than 5 years, or
 - a lease whose term is more than 5 and not more than 7 years, provided that the following conditions are met –
 - (a) the lease would be treated as a finance lease under generally accepted accounting practice,
 - (b) the residual value of the asset implied in the lease is not more than five per cent of the fair value of the asset at commencement, as estimated at inception, and
 - (c) the rentals due in any year do not vary by more than the amounts specified in paragraphs 2.33 and 2.34 below.
- 2.32 The requirement for a lease with a term of more than 5 years to be treated as a finance lease means that an operating lease with a term of more than 5 years cannot be a short lease.
- 2.33 The amounts by which the rentals may vary is determined by looking at the rentals payable over various 12 month periods, namely:
- (a) the first reference year is the period of 12 months beginning with the day next after the commencement of the term of the lease;
 - (b) the other reference years are successive periods of 12 months each beginning on an anniversary of that day and ending before the last day of the term of the lease;
 - (c) the final year is the period of 12 months ending with the last day of the term of the lease.
- It follows that any part of the final year, other than the last day, may also be part of a reference year.
- 2.34 To be a short lease, the rentals in the first reference year must –
- (a) not be more than 10% less than the rentals for the next reference year, and
 - (b) the rentals payable in the final year or any reference year after the second must not be more than the rentals due for the second reference year.
- 2.35 In deciding whether a lease is a short lease, the decision should be taken at inception. In taking that decision, changes that might arise due to variations in interest rates are ignored.
- 2.36 Any other known causes of variation should be taken into account. Variations that could not reasonably be predicted (such as result from tax variation clauses) need not be taken into account.
- 2.37 These rules mean that the rentals payable in the first year may be much higher than those payable in subsequent years and that rentals may decrease by any amount over the term of the lease. In addition, and in broad terms,

rentals should not increase significantly at any point during the term of the lease.

Avoidance

- 2.38 There is an anti-avoidance rule in s.70I(9) CAA that applies where –
- the inception of the lease is on or after 7 April 2006,
 - the lease would otherwise be a short lease,
 - at the time that lease is entered into arrangements are entered into for the asset to be leased to others, and
 - the total of the lease terms exceeds 5 years.

Where the rule applies, the lease is not a short lease

- 2.39 Example The Alphabet Shipping Group wishes to lease a ship for ten years and arranges for a ship to be leased by Bassetshire Bank to group company A Ltd for years 1 to 5 and by to fellow group member B Ltd for years 6 to 10. The lease from Bassetshire Bank to A Ltd is not a short lease.

There is no requirement for the leases to be to connected parties and the rule would apply if A Ltd and B Ltd were not connected.

Inception and commencement (s.70YI CAA)

- 2.40 The legislation distinguishes between "inception" and "commencement" in a similar way to IAS 17. The definitions are in s.70YI CAA.

- 2.41 The inception of a lease is the earliest date when –
- there is a contract in writing for the lease between the lessor and lessee,
 - the contract is unconditional or, if it is conditional, the conditions have been met, and
 - no terms remain to be agreed.

- 2.42 The definition of inception is simpler than the definition in IAS 17, however it is likely that in most cases the two definitions will give the same date. Note that where a business follows SSAP 21 the definition of inception is closer to the concept of commencement in IAS 17 and s.70YI CAA.

- 2.43 Section 70YI defines "commencement" as –
- the date on and after which the lessee is entitled to use the complete leased asset under the lease; for this purpose an asset is to be regarded as complete if its construction is substantially complete.

The use of the term "substantially complete" means that relatively minor works that may be needed following the date when the lessee is entitled to use the asset do not delay the date of commencement of the lease term.

- 2.44 A lessee may be entitled to "use" an asset even if it only used for trials etc, as well as use for its final intended purpose.

Assets that take a long time to construct

2.45 A lessor may make stage payments prior to commencement but under generally accepted accounting practice these should not be recognised as the net investment in the lease until commencement of the lease term.

2.46 Example A lessor bank pays for a ship by three instalments of £10m on 1 June 2007, 1 June 2008 and 1 June 2009. The ship is leased out under a long funding finance lease and delivered to the lessee immediately it is complete on 1 June 2009.

The lessor records its investments of £10m on 1 June 2007 and £20m on 1 June 2008 as financial assets (or possibly as fixed assets if the nature of the lease was uncertain). The lessor's net investment in the lease is first recognised on 1 June 2009 as £30m.

Term of a lease (s.70YF CAA)

2.47 In order to decide whether a lease is a long funding lease or not, it is necessary to establish the term of the lease.

2.48 The term of the lease is defined in s.70YF CAA as –

- the period following commencement of the lease that is not cancellable (paragraph 2.50), plus
- any periods covered by one or more options that, at the inception of the lease, it is reasonably certain the lessee will exercise (paragraph 2.52).

2.49 The test is performed independently by lessor and lessee and as a consequence it follows that, although in most cases it would be expected that lessor and lessee would take the same view, it is possible for them to take different views regarding the term of the lease.

"Non-cancellable"

2.50 A period is non-cancellable if it can be cancelled only –

- on the occurrence of a remote contingency, or
- on payment of a sum that, at the inception of the lease is unlikely to be paid, with the result that continuation of the lease is reasonably certain.

2.51 Example Fred leases a printing press for 10 years from Bassetshire Bank. The first three years of the lease cannot be cancelled for any reason. The final seven years can be cancelled on payment of £6,000 before the end of year 3. Fred would not be guaranteed any rebate if the printing press were sold by Bassetshire Bank. The present value of the rentals for the last seven years of the lease is around £6,000. Fred has to pay roughly the same amount whether he leases the press or not. He is unlikely to pay £6000 to cancel the lease as he would be expected to continue to pay the lease rentals and enjoy the use of the press.

"Reasonably certain"

2.52 The term "reasonably certain" takes its natural meaning. The following simple examples illustrate our views.

2.53 These examples assume very simple facts. If there are side letters or other material facts then the consequences could be different. As always, establishing the facts is essential.

Example 1

Lessor Harold leases machines that cost £4000 each. Lease rentals are £1000 a year. Minimum lease period is 5 years. At the 5-year point, each lessee can either –

- walk away without further payment, whether by not exercising an option to extend the lease term or exercising an option to terminate it, or
- carry on renting the machine for £1000 a year.

In most cases it would not be reasonably certain that the lessees would exercise an option to extend the lease term.

If, for example, Harold knew from experience that on average 10% will extend beyond 5 years (but it is not known which 10%) then none of the leases are reasonably certain to extend beyond 5 years.

However, if Harold knew that all, or almost all, lessees exercised an option to extend the contract then it would be reasonably certain that the options would be exercised.

Example 2

Lessor Isobel leases machines that cost £4000 each and typically have a life of 5 to 10 years. Lease rentals are £1000 a year. Minimum lease period is 5 years. At the 5 year point, each lessee can either –

- carry on renting the machine for £10 a year, or
- terminate the lease and require the lessor to sell the machine and repay an amount equivalent to 99% of the net sale proceeds by way of a rebate of rentals.

On the facts, it is not clear which option would be beneficial and so the lessee is not reasonably certain to exercise the option to extend the lease term.

Example 3

A ship costs lessor Jacob £45m. The ship has an expected useful life of 20 years. Jacob leases the ship to Keith for 5 years at the market rate for a 5-year charter: say £5m a year. After 5 years Keith can either –

- walk away without being required to pay the lessor anything more, or
- extend the lease term for another 5 years at the market rate applying at that time.

Keith is not reasonably certain to exercise the option to extend the lease term.

Example 4

A ship cost lessor Leonard £45m. The ship has an expected useful life of 20 years. Leonard leases the ship to Meredith for 5 years at £10m a year. After 5 years Meredith can either –

- walk away without being required to pay the lessor anything more, or
- extend the lease term for another 15 years at a rental of £0.1m a year.

On the facts it appears that it would make no commercial sense for Meredith not to exercise the option and so Meredith is reasonably certain to exercise the option to extend the lease term.

Avoidance - term of lease artificially shortened

- 2.54 In order to avoid the lease being classified as a long funding lease arrangements could be entered into with the intention of presenting a lease as having a term that is shorter than the parties actually intend it to be.
- 2.55 For example, what is intended by a lessor and lessee to be a long lease might be structured as a short lease with an option to extend the term of the lease. Such a lease could be structured so that it was arguable that it was not "reasonably certain" that the option to extend would be exercised.
- 2.56 The anti-avoidance rule has the effect of reversing the "reasonable presumption" test. It applies where –
- at the commencement of the lease term:
 - the asset has a value in excess of £1 million, and
 - the estimated market value of the asset 5 years after commencement is more than half the market value of the asset at commencement, and
 - the term of the lease would otherwise be no more than 5 years (and so a short lease), and
 - the lessee has one or more options to extend the lease term and on the assumption the lessee would exercise that option (or options) the term would exceed 7 years, and
 - on failing to exercise any one of those options, the lessee may be required to make a payment to the lessor that would not have been payable had the option been exercised.
- 2.57 Where these conditions are met then the term of the lease is arrived at by assuming the options will be exercised unless it is reasonably certain that the options will not be exercised.

Market value (s.70YI(2) CAA)

- 2.58 The "market value" of any plant or machinery is to be determined on the assumption that the asset is disposed of by its absolute owner, free from all leases and other encumbrances.
- 2.59 This definition of market value in s.70YI(2) applies to Chapter 6A of the Capital Allowances Act (sections 70F to s.70YI) and provisions that import that Chapter (e.g. Chapters 5A of ICTA and 10A of ITTOIA).

Plant or machinery leased with other assets (ss.70L and 70M CAA)

Outline

- 2.60 In broad terms, where plant or machinery is leased with other assets, the plant or machinery is treated as if it were the subject of a separate notional lease. Where different types of plant or machinery are leased under the

same lease they too are treated as if they are subject to separate notional leases. The tests for a long funding lease, and the rules for taxing them, are then applied to each notional lease of plant or machinery.

- 2.61 This approach will apply where, for example, an item of manufacturing plant is leased with land (but see paragraphs 2.72 and 2.81 regarding the treatment of certain plant or machinery that is leased with land).

Detail

- 2.62 Leases of different types of plant or machinery, or of plant or machinery and other assets, are referred to as “mixed leases”. In each case the plant or machinery is referred to as the “relevant plant or machinery” (s.70L(1) CAA).

- 2.63 The legislation only applies to “eligible mixed leases”, that is leases that –
- would be treated as a lease under generally accepted accounting practice (and see paragraph 2.64), or
 - the relevant plant or machinery is the subject of a sale and finance leaseback and the mixed lease is, or includes, the finance lease in the sale and finance leaseback (s.70L(2) CAA).

This reflects the provisions of s.70K CAA (definition of plant or machinery lease).

- 2.64 An agreement or arrangement that would be treated as a lease under generally accepted accounting practice immediately after the commencement of the term of the lease is treated as a lease during the pre-commencement period. The pre-commencement period is the period from the inception of the lease to the commencement of the term of the lease (s.70L(3) and (4) CAA).

- 2.65 Where a lease is an eligible mixed lease, it is treated as two or more separate leases of the relevant plant or machinery and of the other assets. These notional separate leases are called “derived leases”.

- 2.66 Section 70M CAA sets out the way in which the term and rentals for the derived lease are to be calculated. Once that has been done, the rules in s.70G CAA establish whether the derived lease is a long funding lease.

- 2.67 The normal rules apply to determine the term of a derived lease except that its term is limited to the remaining useful economic life of the relevant plant or machinery at the beginning of the term of the derived lease. So, for example, if the remaining useful economic life of the relevant plant or machinery at the beginning of the term of the derived lease is 20 years but the normal rules would make its term 35 years, its term is 20 years.

- 2.68 Different items of plant or machinery may be treated in different ways. For example, if two different machines were leased together, and one machine had a life of 10 years but the other had a life of 20 years, a different lease would be deemed in respect of each, one with a term of 10 years, the other with a term of 20 years.

- 2.69 A just and reasonable apportionment is required to decide what part of the rentals payable under the mixed lease should be treated as payable under each derived lease (the deemed rentals).

- 2.70 The rentals under the derived lease are treated as payable in equal instalments unless it would be reasonable to use a different treatment having regard to all the circumstances of the case. The circumstances to take into account include –
- the provisions of the eligible mixed lease,
 - the nature of the relevant plant or machinery, the value of the relevant plant or machinery at the beginning of the term of the derived lease,
 - the expected market value of the relevant plant or machinery at the end of the term of the derived lease,
 - the remaining useful economic life of the plant or machinery when the term of the derived lease begins, and
 - the term of the derived lease.
- 2.71 The deemed rentals payable under any derived lease for any period should not exceed the rentals actually payable under the eligible mixed lease.

Excluded leases – background plant or machinery (s.70R CAA)

- 2.72 As a general rule, plant or machinery that is leased with other assets is the subject of a derived lease (paragraph 2.62) and so potentially within the scope of the rules for taxing long funding leases.
- 2.73 However, where the plant or machinery is –
- affixed to or otherwise installed in or on land which includes a building,
 - background plant or machinery, and
 - leased with the land under a mixed lease
- the derived lease of the plant or machinery is an excluded lease of background plant or machinery for a building.
- 2.74 The background plant or machinery for a building is plant or machinery –
- of a type that might reasonably be expected to be installed in various types of building, and
 - whose sole or main purpose is to make the building usable.
- For example, lifts and central heating are found in many types of building and both types of plant and machinery are background plant or machinery.
- 2.75 In order to add certainty concerning what is, and what is not, background plant or machinery, the Treasury may make an order describing the types of plant deemed to be background plant or machinery and the types of plant deemed not to be background plant or machinery.
- 2.76 A draft of proposed Regulations is in Annex A on page 56.

Disqualifications

- 2.77 The legislation excluding background plant or machinery from being classified as a long funding lease does not apply where:

- the amounts payable under the mixed lease (i.e. the lease of the building and the plant or machinery) or any other arrangements vary or may be varied by reference to the value to the lessor of the plant and machinery allowances on the background plant or machinery;
- the main purpose, or one of the main purposes, of the mixed lease is to stop the long funding lease legislation applying to the background plant or machinery so that the lessor gets plant and machinery allowances on it.

2.78 The reference to “any other arrangements” ensures that the disqualification applies where the payments under the lease remain unaltered but other payments are or may be varied as a result of the value to the lessor of the plant or machinery.

Residential property

2.79 Lessors of residential property are not generally entitled to claim capital allowances on any plant or machinery it may contain because s.35 CAA denies capital allowances for expenditure "incurred in providing plant or machinery for use in a dwelling-house".

2.80 Some leasing of residential property such as blocks of flats may include expenditure on lifts and air-conditioning etc in the common parts. These qualify for capital allowances but it is accepted that they are wholly incidental to the lease of the property itself, and so qualify as background plant or machinery. As a consequence, leases of residential property will not include long funding leases unless the lease includes plant or machinery that does not fall within the definition of background plant or machinery. (For this to be the case, the lease would have to include plant or machinery that is not normally found in residential property and which is not there to contribute to the functionality of the building as residential property.)

Excluded leases – plant or machinery leased with land: low percentage value (s.70U CAA)

2.81 Section 70U applies where plant and machinery which is not background plant and machinery is affixed to land and is leased with the land under a mixed lease.

2.82 In such a case, the derived lease of the plant and machinery is an excluded lease if the aggregate of the market value of that plant or machinery and the market value of any other plant or machinery leased along with the land that is not background plant or machinery is less than both –

- 10% of the aggregate market value of all the background plant or machinery leased with the land, and
- 5% of the market value of the land including buildings and fixtures.

2.83 Mortgages, leases and other encumbrances are ignored when determining the market value of the land.

Amendments to a lease

2.84 Amendments to a lease may create a new lease in three circumstances –

- (a) an amendment may trigger a specific rule in Schedule 8 that deems a new lease to have commenced even where it has not (e.g. s.70YA, s.70YB, s.70YC and s.70YD CAA), or
 - (b) there may be a new derived lease under s.70L CAA, or
 - (c) it falls to be treated as a new lease as a matter of law.
- 2.85 With regard to (c) we regard material amendments to a lease as potentially creating a new lease, whether or not the documentation purports to show otherwise. We do not regard minor amendments to a lease, such as making small changes to the lease rentals as a result of incurring additional expenditure on the asset, as creating a new lease. Where there are more substantial changes it will be necessary to look at the facts before deciding whether the existing lease continues or whether a new lease has been created.
- 2.86 A lease can only be affected by the provisions of Schedule 8 FA 2006 where it falls within the commencement provisions in paragraph 15 of the Schedule (paragraphs 7.1 and 7.2 below). Therefore leases that are not generally affected by Schedule 8 can only be brought within Schedule 8 if they are amended such that a new lease is created and that new lease falls within the commencement provisions.
- 2.87 Where a lease is a long funding lease and the lessor incurs additional capital expenditure on the leased asset the provisions of s.70L will create a derived lease if the additional expenditure is on an asset of a different kind. Where the expenditure does no more than enhance the existing asset, no derived lease will be created under s.70L.
- 2.88 Example 1 A lessor leases a train to a rail franchisee in 2001. In 2007, the lessor incurs additional capital expenditure upgrading the safety systems which are expected to last for the remaining useful economic life of the train. The lease rentals are increased to reflect that expenditure, but no other changes are made.
- The leased asset is the train and the additions are not sufficiently material to create a new lease.

3 LESSORS – GENERAL RULES

- 3.1 The basic principle for taxing long funding lessors is to treat the lease as if it were a financing transaction, similar to a loan, though the loan relationships legislation does not apply.
- 3.2 The taxation of lessors depends on whether the lease is a long funding finance lease or a long funding operating lease.
- A long funding finance lease is a long funding lease that is (or should be) accounted for by the lessor as a finance lease under generally accepted accounting practice.
 - A long funding operating lease is a long funding lease that is (or should be) accounted for by the lessor as an operating lease under generally accepted accounting practice.
- 3.3 Therefore if a long funding lease is accounted for by the lessor as an operating lease but by a connected party as a finance lease it is a long funding operating lease. This is so, even though it may be a funding lease because it meets the finance lease test by virtue of s.70N(1)(b) CAA.

Capital allowances

Plant or machinery acquired for long funding leasing

- 3.4 Section 34A CAA (inserted by paragraph 3 of Schedule 8) prevents lessors from being entitled to capital allowances where plant or machinery is acquired for long funding leasing. Plant or machinery acquired for any other type of leasing enters the capital allowance regime in the usual way.

Disposal values etc

- 3.5 Paragraph 5 of Schedule 8 amends s.61 CAA to provide the mechanism for creating a disposal value when plant or machinery that has qualified for capital allowances begins to be used for long funding leasing.
- 3.6 New s.61(1)(ee) creates a disposal event when plant or machinery begins to be used for long funding leasing.
- 3.7 Where the lease is a long funding finance lease the disposal value is an amount equal to that which would fall to be recognised as the lessor's net investment in the lease if accounts were prepared in accordance with generally accepted accounting practice on the date on which the lessor's net investment in the lease is first recognised in the books or other financial records of the lessor (item 5A of the table in s.61(2) CAA).
- 3.8 Where the lease is a long funding operating lease, the disposal value is an amount equal to the market value of the plant or machinery at the commencement of the term of the lease (item 5B of the table in s.61(2) CAA).
- 3.9 The disposal value is limited to cost by s.62 CAA, as normal.

Plant or machinery previously used for long funding leasing

- 3.10 Paragraph 2 of Schedule 8 inserts new s.13A CAA. This section allows a person that has used plant or machinery for long funding leasing to claim capital allowances when the plant or machinery begins to be used for a qualifying activity that is not long funding leasing.
- 3.11 The amount on which capital allowances may be claimed is the amount (the termination amount, see s.70YG CAA) that is taken into account for the purpose of determining tax liability at the end of the previous long funding lease.
- 3.12 Paragraph 4 of Schedule 8 makes a consequential amendment to s.46 CAA (general exclusions for first year allowances) so that plant or machinery that is eligible for capital allowances under s.13A is not eligible for first year allowances. This is the same as where plant or machinery becomes eligible for capital allowances under s.13 (plant or machinery becoming used for a qualifying activity).

Income and expenditure

Corporation tax and income tax

- 3.13 The taxation of income and expenditure is governed by ICTA for corporation tax and by ITTOIA for income tax. The following comments refer only to ICTA, but essentially the same principles apply to the equivalent sections in ITTOIA.

Long funding finance leases

- 3.14 Section 502B ICTA provides that long funding finance lessors are taxed on the rental earnings that are shown in the accounts, or which would be shown if accounts were prepared in accordance with generally accepted accounting practice.
- 3.15 Where a lease is accounted for as a loan the lessor is taxed on the amount that is, or should be, shown as interest in accounts prepared under generally accepted accounting practice. (Although the income is accounted for as interest it does not arise from a loan relationship and so the loan relationships legislation does not apply.)
- 3.16 Some profits or losses arising under a lease may not be accounted for through rental earnings or as interest. Section 502C ICTA applies to a profit or loss (whether capital or revenue in nature) that –
- arises in connection with the lease, and
 - falls to be recognised as a profit or loss under generally accepted accounting practice, and
 - would not otherwise be brought into account for tax purposes.
- 3.17 Where this is the case any profit is treated as income attributable to the lease. Therefore if the rental earnings would be taxed under case I of Schedule D, so is the exceptional profit. But if, for example, the rental earnings would be

taxed under Schedule A (as may be the case with fixtures) the exceptional profit would also fall to be taxed under Schedule A.

- 3.18 Similar principles apply to a loss, which is treated as if it was revenue expenditure incurred in connection with the lease.

Long funding finance leases - termination

- 3.19 Where a finance lease of plant or machinery comes to an end the plant or machinery is usually sold. The lessor usually passes the majority of the sale proceeds in excess of the residual value to the lessee in the form of a rebate of rentals. As the lessor is taxed only on the rental earnings in accordance with s.502B (rather than on the full amount of the rentals receivable), no deduction in respect of this payment to the lessee is appropriate.

- 3.20 Example This example assumes the asset has been leased under a single finance lease throughout its life. Assume –

- an asset cost £20,000 and is leased under a finance lease with an expected residual value of £1,000,
- at the end of the lease the asset is sold for £1,500,
- the lessor is entitled to £1,000 (the expected residual value at inception) plus 5% of the balance of £500, a total of £1,025, and
- the lessee receives 95% of the balance (i.e. £475).

The lessor uses £1,000 of the disposal proceeds to eliminate his net investment in the lease. The remaining £25 net profit to which the lessor is entitled is likely to be accounted for as part of rental earnings.

- 3.21 The rent rebate of £475 does not pass through the lessor's profit and loss account. The £475 is, of course, netted off against the £500 profit from the sale and no further deduction is needed. If a deduction were otherwise available it is prohibited by s.502D.

- 3.22 If the asset had been sold for £400 then the lessee would not have been entitled to any rebate. The lessor's loss of £600 would either pass through rental earnings or the profit and loss account. Either way, the loss would be recognised for tax purposes, ensuring the lessor remains taxed on its commercial profit over the life of the lease.

Long funding operating leases

- 3.23 Section 502E ICTA sets out the basic rules for taxing lessors under long funding operating leases.

- 3.24 Where an asset is leased out under a long funding operating lease then, to reflect the lack of capital allowances, s.502E reduces the lessor's income by an amount that is established at commencement.

- 3.25 In outline, the deduction is the amount by which the asset is expected to fall in value over the term of the lease, apportioned on a time basis to each period of account over the term of the lease. The deduction for each period is referred to as the "periodic deduction".

3.26 The periodic deduction is based on –

- relevant value (often cost, but see paragraph 3.27 below), less
- the amount, which at the commencement of the term of the lease, is expected to be the residual value of the plant or machinery.

The residual value is the estimated market value of the plant or machinery if it were disposed of at the end of the lease, less the estimated costs of disposal (s.502L(2) ICTA).

The resulting value is referred to as the gross reduction over the term of the lease and this is apportioned on a time basis over that period.

3.27 The starting point for this calculation, the “relevant value”, depends on the circumstances (s.502E(4) CAA). The relevant value is –

- if the asset was acquired for the purpose of a particular long funding operating lease, cost;
- if the asset was last used in a qualifying activity for another long funding operating lease, market value;
- if the asset was last used in a qualifying activity for a long funding finance lease, the value at which the plant or machinery is recognised in the books or other financial records of the lessor at commencement of the operating lease;
- if the asset was last used by the lessor for the purpose of a qualifying activity other than leasing under a long funding lease, the lower of cost and market value;
- if the lessor owns the plant or machinery as a result of having incurred expenditure on its provision for purposes other than those of a qualifying activity (perhaps because the expenditure was incurred before the lessor became resident in the UK), but –
 - the plant or machinery is brought into use for a qualifying activity on or after 1 April 2006, and
 - that leasing of plant or machinery is part of that qualifying activity

the relevant value is the lower of –

- the market value at commencement, and
- the first use amortised value.

The first use amortised value is the value that the plant or machinery would have had when it was first brought into use for the purposes of the qualifying activity on the assumption that the costs and any additional costs had been written off on a straight line basis.

3.28 Example A lessor acquires a new ship for £40m. The ship is leased out for 15 years under long funding operating lease. At commencement it is estimated that the market value of the ship at the end of the lease term will be £10m.

The expected reduction in value is £30m. This is spread over the term of the lease, so that, for each full year, a deduction of £2m is available,

If the lessor has a year-end of 31 December and the lease commences on 1 July 2008 the available deduction in the year to 31 December 2008 is $£2,000,000 \times 184 / 365 = £1,008,219$.

Long funding operating leases - Additional capital expenditure

- 3.29 If the lessor incurs further capital expenditure on the asset, it will not qualify for capital allowances as s.34A CAA applies to this additional expenditure as it does to the original expenditure (by virtue of the existing s.571 CAA). In this situation s.502F ICTA applies to further reduce the lessor's income for tax purposes, to reflect the fact that further expenditure has been incurred for which no relief would otherwise be available.
- 3.30 The effect of this section is explained in the following example.
- 3.31 Example An asset cost £20,000. It is leased out under a long funding operating lease for 15 years at £1,300 a year. The lessor incurs further capital expenditure of £5,000 at the end of year 5 and increases the rental by £600 a year. At the end of year 5, and following the additional capital expenditure, the expected market value at the end of year 15 is £6,000.

Section 502E

- The relevant value = £20,000
- The expected residual value = £5,000
- The gross expected reduction in value = £15,000
- The annual deduction in each of the 15 years of the lease = $£15,000 / 15 = £1,000$.

Section 502F

- The expected value at end of year 15 as at the end of year 5 (ARV) = £6,000
- The original expected residual value (CRV) = £5,000
- The sum of any amounts that fell to taken into account as RRV (see next bullet) in respect of previous additional expenditure (PRV) = 0
- $TRV = CRV + PRV = £5,000$
- ARV (£6,000) exceeds TRV (£5,000) and so $RRV = £1,000$
- The expected partial reduction is the additional expenditure (£5,000) less the RRV (£1,000) = £4,000;
- This results in an additional deduction in years 6 to 15 of £400 a year.

Long funding operating leases - termination

- 3.32 The provisions of s.502G ICTA apply when a long funding operating lease comes to an end. The provisions are complex and can be illustrated by continuing the example in paragraph 3.31.

Example Assume that the asset in the example above is sold for what turns out to be its market value of £7,000 at the end of year 15 and that nothing is paid to the lessee, even though the market value exceeds the expected value.

The first steps are to find –

- the termination amount (defined in s.70YG). In this case s.70YG(3) applies as a plant or machinery disposal event (the sale) occurs as a result of (or in connection with) the termination of the lease and so the termination amount (TA) is £7,000.
- the total of any sums paid to the lessee that are calculated by reference to the termination value (LP). The termination value is defined in s.70YH CAA but as nothing was paid to the lessee, in this case LP is 0.

The second steps are to find –

- the relevant value for the purpose of s.502(E)(6)(a) (RV). In this example it is £20,000.
- the total of the deductions allowable under s.502E (TD1). In this example it is $15 \times £1,000 = £15,000$.
- the amount (ERV) by which RV exceeds TD1. In this example it is £5,000.

The third steps are to find –

- the amount of any additional expenditure for the purpose of s.502F (TAE). In this example it is £5,000.
- the total of the deductions allowable under s.502F (TD2). In this example it is $10 \times £400 = £4,000$.
- the amount (EAE) by which TAE (£5,000) exceeds TD2 (£4,000). In this example it is £1,000.

Step 4 is to add ERV (£5,000) and EAE (£1,000) to give T. Here T is £6,000.

As (TA-LP) (£7,000) exceeds T (£6,000), the lessor is treated as making an additional profit of £1,000.

In summary the commercial position is:

Rentals – years 1 - 5	$5 \times 1,300 =$	6,500
Rentals – years 6 - 15	$10 \times 1,900 =$	19,000
		<u>25,500</u>
Cost		-20,000
Additions		-5,000
Sale proceeds		7,000
Overall profit		<u>7,500</u>

And the overall tax position is:

Rentals – years 1 - 5	$5 \times 1,300 =$	6,500
Rentals – years 6 - 15	$10 \times 1,900 =$	19,000
		<u>25,500</u>
Deductions s.502E		-15,000
Deductions s.502F		-4,000
Additional profit s.502G		1,000
Overall profit		<u>7,500</u>

Bad debts

- 3.33 Where a debt under a long funding finance lease turns out to be bad the bad debt may be reflected in a reduction in rental earnings and/or as a loss elsewhere in the accounts. The loss will therefore be relieved under s.502B or s.502C, as appropriate.
- 3.34 Any later recovery of the bad debt would be taxed under s.502C unless it was taken through rental earnings, in which case it would be taxed under s.502B.
- 3.35 A bad debt under an operating lease is allowable in the normal way as it will be unaffected by the long funding lease provisions.

4 LESSEES – GENERAL RULES

- 4.1 In broad terms, lessees under long funding leases are treated as having bought the asset. This allows a lessee to claim plant or machinery allowances.
- 4.2 The amount of rentals that is allowed as a deduction in computing profits is restricted to compensate for the availability of capital allowances.
- 4.3 As with lessors (paragraph 3.2), the tax rules depend on whether the lease is a long funding finance lease or a long funding operating lease.

Entitlement to capital allowances

- 4.4 Paragraph 6 of Schedule 8 inserts sections 70A to 70E into CAA. These new sections provide for long funding lessees to claim capital allowances.
- 4.5 Where a lessee carries on a qualifying activity s.70A treats the lessee as –
- incurring capital expenditure on the provision of the asset at the commencement of the term of the long funding lease and
 - owning the asset as a result of incurring that expenditure.
- 4.6 This means that the lessee satisfies the conditions for claiming plant and machinery allowances based on the capital expenditure they are treated as incurring. The capital expenditure that the lessee is treated as incurring depends upon whether the lease is long funding finance or a long funding operating lease.
- 4.7 It does not matter if the lessee's expenditure under the long funding lease is capital or revenue. In both cases the lessee is deemed to have incurred capital expenditure on the provision of the asset.
- 4.8 Sections 70B and 70C CAA define the amount of capital expenditure that is deemed to have been incurred by a long funding lessee.

Lessee's capital expenditure

- 4.9 The amount of a long funding lessee's deemed capital expenditure depends on whether the lease is a finance lease or an operating lease.

Long funding operating lease (s.70B CAA)

- 4.10 If the lease is a long funding operating lease the lessee's capital expenditure is the market value of the asset at the later of –
- the commencement of the term of lease, and
 - the date on which the asset is first brought into use by the lessee for the purposes of the qualifying activity.

The market value is arrived at ignoring the lease (s.70Y1 CAA).

Long funding finance lease (s.70C CAA)

- 4.11 If the lease is a long funding finance lease the basic rule is that the lessee's capital expenditure is the present value of the minimum lease payments at the appropriate date. The appropriate date is the later of –
- the commencement of the term of the lease and
 - the date on which the lessee first brings the asset into use for the purposes of the qualifying activity.
- 4.12 The present value of the minimum lease payments at the appropriate date is calculated on the assumption that accounts were prepared in accordance with generally accepted accounting practice (as defined in s.50 FA 2004). The present value of the minimum lease payments at the appropriate date is the amount that would fall to be treated as the present value of the minimum lease payments in the lessee's accounts at the appropriate date.
- 4.13 If a long funding lease is accounted for as a loan the lessee's capital expenditure is calculated in a similar way.

Finance lease – pre-commencement rentals (s.70C CAA)

- 4.14 If the lessee pays rentals under a finance lease before the term of the lease begins and relief is not available for those rentals any other way, they are added to the present value of the minimum lease payments at the commencement of the lease to arrive at the lessee's capital expenditure. For example, the lessee may have accounted for the pre-commencement rentals as loan repayments. If so, only the interest element will be an allowable deduction in computing profits. The lessee adds the capital element of the loan repayments made before the term of the lease begins to the present value of the minimum lease payments at the commencement of the lease.

Lessor's additional capital expenditure – long funding finance leases (s.70D CAA)

- 4.15 Section 70D CAA provides for lessees under long funding finance leases to be entitled to further capital allowances where the lessor incurs additional expenditure on the asset (perhaps enhancing it to increase capacity). The corresponding increase in the present value of the minimum lease payments qualifies for capital allowances.

Lessor's additional capital expenditure – long funding operating leases

- 4.16 There is no equivalent of s.70D for lessees under long funding operating leases. The amount on which capital allowances is claimed remains the same, as does the limit on deductions (paragraph 4.24). It follows that a lessee under a long funding operating lease will receive relief as a revenue deduction for any increased rentals payable.

Leases accounted for as loans

- 4.17 Sections 70C and 70D also apply to leases that are accounted for as loans (see subsection (2) of each section).

Lease rental restriction (s.502I to 502J ICTA)

- 4.18 Lessees under long funding leases obtain relief for part of the lease rental payments by way of capital allowances.
- 4.19 It follows that it is necessary to restrict the relief that would otherwise be available for rentals payable under the lease.

Corporation tax and income tax

- 4.20 The taxation of income and expenditure is governed by ICTA for corporation tax and by ITTOIA for income tax. The following comments refer only to ICTA, but essentially the same principles apply to the equivalent sections in ITTOIA.

Lessees under long funding finance leases – limit on deductions (s.502I ICTA)

- 4.21 In the case of a long funding finance lease, the lease rentals are restricted to the finance charges that are (or would be) shown in accounts prepared under generally accepted accounting practice.
- 4.22 The same principle applies where, exceptionally, the lease is accounted for as a loan.

Lessees under long funding finance leases – terminations (s.502J ICTA)

- 4.23 A finance lessee may receive a sum at the end of the term of a lease, whether the lease runs to full term or not. This is often referred to as a refund of rentals. Under general principles this refund would be taxable as income of the trade or other activity, but in the case of a long funding lease it is taken into account in computing the disposal value (paragraph 4.40). Therefore s.502J ICTA ensures that this sum is not brought into account as income under general principles.

Lessees under long funding operating leases (s.502K ICTA)

- 4.24 Section 502K restricts the deductions that may be allowed in computing profits.
- 4.25 The amount of the restriction is based on –
- relevant value (paragraph 4.26), less
 - the amount which, at the commencement of the term of the lease, is expected to be the market value of the plant or machinery at the end of the term of the lease.

The resulting value is referred to as the expected gross reduction over the term of the lease and is apportioned to each period of account on a time basis.

- 4.26 The relevant value is usually the market value of the plant or machinery at the commencement of the term of the lease.

- 4.27 However, if the lessee –
- has the use of the plant or machinery as a result of having incurred expenditure on its provision for purposes other than those of a qualifying activity, and
 - brings the plant or machinery into use for the purposes of a qualifying activity on or after 1st April 2006,
- then the residual value is the lower of –
- first use market value, and
 - first use amortised market value.
- 4.28 "First use market value" means the market value of the plant or machinery when it is first used for the purposes of the qualifying activity.
- 4.29 "First use amortised market value" means the value that the plant or machinery would have at the time when it is first brought into use for the purposes of the qualifying activity, but on the assumption that the market value of the plant or machinery at the commencement of the term of the lease had been written off on a straight line basis over the remaining useful economic life of the plant or machinery.
- 4.30 Example On 1 July 1998 an item of plant was bought for the equivalent of £10m by Lessor SA, a French resident. The plant was expected to have a useful life of 25 years and was leased out on the day it was acquired under a lease with a primary term of 20 years.
- Lessor SA moves to the UK, becoming resident on 1 July 2008 and beginning to carry on a qualifying activity at that time.
- The plant is 10 years old on 1 July 2008 and on the basis that it had an expected useful life of 25 years, the first use amortised value is £6m.

Disposal events and disposal values (s.70E CAA)

Disposal events

- 4.31 Where a lessee is entitled to capital allowances as a result of s.70A CAA the termination of the lease is a disposal event and the lessee is required to bring a disposal value into account.
- 4.32 The disposal value is brought into account for the chargeable period in which the lease terminates.
- 4.33 These rules apply whether the lease comes to an end at the end of its term, or whether it terminates early.
- 4.34 There are different rules depending on whether the lessee has treated the lease as a long funding operating lease or a long funding finance lease.

Disposal values - long funding operating lease

- 4.35 Where a lessee has treated a lease as a long funding operating lease the disposal value is the sum of two elements, A and B.

- 4.36 Element A is the amount (if any) by which the market value of the plant or machinery at the later of –
- the commencement of the term of lease, and
 - the date on which the asset is first brought into use by the lessee for the purposes of the qualifying activity
- exceeds
- the deductions that have been made under s.502K ICTA (paragraph 4.24).
- 4.37 Element B is the amount payable to the lessee that has been calculated by reference to the termination value (s.70YH CAA).
- 4.38 The general rule is that the termination value of an asset is the value of the asset when the lease terminates. It includes the following –
- if the plant or machinery is sold when the lease terminates the termination value is the sale proceeds;
 - if the lessor receives insurance proceeds or other compensation for the plant or machinery when the lease terminates the termination value is those insurance proceeds or compensation;
 - if the asset is not sold etc, the termination value is the estimated market value of the plant or machinery.
- 4.39 Example Harold leased an aircraft to George under a long funding operating lease for 15 years. At the end of the lease, George is entitled to £1m if the value of the aircraft exceeds £10m. At the end of the lease the aircraft is valued at £12m and so George is paid £1m. Harold did not sell the aircraft but chose to lease it out again.

Element B of George's disposal value is £1m.

Disposal values - long funding finance lease

- 4.40 The following comments apply where a lessee has treated a lease as a long funding finance lease.
- 4.41 If the lease runs to its full term the disposal value is the amount of any payment received by the lessee from the lessor (often referred to as a refund of lease rentals).
- 4.42 If the lease terminates early the disposal value is the sum of –
- any amount receivable by the lessee which has been calculated by reference to the termination value, and
 - the amount that would be the present value of the balance of the minimum lease payments if accounts were prepared
- less
- any amount payable by the lessee to the lessor as a result of the termination.

However, the disposal value cannot be less than nil.

- 4.43 The balance of the minimum lease payments is the minimum lease payments (s.70YE CAA) less what would have been the minimum lease payments if the lease had expired on the termination date. In arriving at that amount it must be assumed that accounts had been prepared in accordance with generally accepted accountancy practice immediately before the termination of the lease.

Preventing two claims to capital allowances (s.70Q CAA)

- 4.44 In some cases a lessee cannot treat a lease as a long funding lease.

The rules

- 4.45 A lessee cannot treat a lease as a long funding lease if the lessor or any superior lessor –
- is entitled to claim plant and machinery allowances at the commencement of the lease term, or
 - has at any earlier time been entitled to capital allowances and has not brought a disposal value to account under s.61(1)(ee) CAA when the long funding lease is granted.
- 4.46 The second of these conditions means that the lessee cannot treat a lease as a long funding lease if the lessor has claimed a capital allowance other than a plant and machinery allowance on the asset. For example, the lessor may have claimed 100% Enterprise Zone Allowance if the asset is in a building in an enterprise zone. If so, the lessee cannot treat the lease as a long funding lease.
- 4.47 If the lessor is not chargeable to tax then these conditions apply as if the lessor were chargeable to tax.
- 4.48 Where a lessee cannot show that no lessor is entitled to plant and machinery allowances, or would not have been entitled to capital allowances had they been chargeable to tax, the lease will not be a long funding lease. Instead the lessee will get a deduction for rental payments in the normal way.
- 4.49 There is a transitional exception to these basic rules. A lessee may claim capital allowances even if the lessor has claimed them provided that the lease is not a funding lease for the lessor only because –
- the plant had been leased for at least 10 years before 1 April 2006
 - the lessor under the plant and machinery lease was also the lessor of the plant on the last day before 1 April 2006 when the plant was leased and the inception of the lease is before 28 June 2006 (s.70Q(5)).

Evidence

- 4.50 Under self assessment it is for the lessee to take appropriate steps to ensure that no lessor is entitled to claim capital allowances, or would be entitled to do so were they within the charge to tax.
- 4.51 It may be that the lessor includes a statement in the lease documentation or elsewhere to the effect that they, and any superior lessors if there are any,

are not entitled to claim capital allowances (or would not be if they were within the charge to tax).

- 4.52 Where a lessor does not make such a statement, and in the event of an enquiry, HMRC would consider alternative evidence.
- 4.53 For example, if the lease is a full payout finance lease it may be reasonable to assume that no lessor is entitled to capital allowances. However, if there are conditions in the lease allowing one asset to be substituted for another it could indicate that a head lessor has a lease for less than the full life of the asset and intends to substitute it at some point.
- 4.54 Where a lease is close to the boundary between a long funding lease and a non long-funding lease (perhaps because the present value of the lease payments is just over 80% of fair value) then the lessee will need to take appropriate steps to show that the statutory test has been met. This may entail obtaining the necessary assurance from the lessor.

Definition of GAAP

- 4.55 Where a lessor is not within the charge to tax because it is based overseas it may be necessary to consider whether the lease is a finance lease under GAAP.
- 4.56 GAAP is defined in s.50 FA 2004 to mean –
 - “(a) in relation to the affairs of a company or other entity that prepares accounts in accordance with international accounting standards (“IAS accounts”), generally accepted accounting practice with respect to such accounts;
 - (b) in any other case, UK generally accepted accounting practice.”
- 4.57 Overseas lessors may use IAS, and if they do then that will be generally accepted accounting practice for the purposes of this test. However they may use their local GAAP rather than IAS, in which case s.50 would normally require them to use UK GAAP. However, for the purpose of this test, where lessor does not produce accounts under UK GAAP or IAS then GAAP means generally accepted accounting practice under IAS (subsections 70Q(3) and (4)).

Lessees may choose to retain existing tax treatment

- 4.58 Lessees may only treat a lease as a long funding lease (and thus claim capital allowances in respect of the leased plant or machinery) if the lessor and any superior lessors are not entitled to claim capital allowances, or would not be entitled to do so were they within the charge to tax.
- 4.59 However, lessees are under no obligation to treat a lease as a long funding lease if they do not wish to do so. A lessee can choose not to be within the long funding lease regime and can claim a deduction for lease rentals in the normal way.
- 4.60 Once a lessee has made a return on the basis that a lease is not a long funding lease, then that establishes the nature of the lease (s.70H CAA). A

lessee can change its mind within the normal period for amending a return, but it is otherwise bound by the treatment adopted in its returns.

- 4.61 Similarly, once a lessee has made a return on the basis that a lease is a long funding lease then that establishes the nature of the lease. (Assuming, of course, that the necessary conditions for the lease to be treated as a long funding lease are satisfied.)

Different treatment by lessor and lessee

- 4.62 The fact that a lessor treats a lease as a long funding lease does not mean that the lessee will treat it as one and vice versa.
- 4.63 If the lessor has not treated the lease as a long funding lease it will be entitled to capital allowances and the lessee will not (s.70Q CAA).
- 4.64 On the other hand, if the lessor treats the lease as a long funding lease but the lessee does not, then neither the lessor nor the lessee will be entitled to capital allowances.

Anti-avoidance (s.70C(7) and (8) CAA)

- 4.65 If the main purpose, or one of the main purposes, of entering into

- the long funding finance lease, or
- a series of transactions of which the lease is one, or
- any transaction in such a series

is to obtain plant or machinery allowances on an amount that materially exceeds the market value of the leased asset at the commencement of the lease the lessee's capital expenditure is restricted to market value.

- 4.66 Example Albert Inc, which is resident in the Cayman Islands, buys an aircraft for its market value of £40m. The aircraft is leased under a long funding finance lease to Bertie Ltd, its UK subsidiary. The present value of the lease rentals is £60m.

The effect of s.70C is that Bertie Ltd can only claim capital allowances on £40m. It would not get any relief for the £20m by which the present value of the lease rentals exceeds the market value of the aircraft.

5 CHAINS OF LEASES

- 5.1 It is common to have arrangements that involve a head lease and sub-lease. In some cases there may be a sub-sub-lease and so on. This guidance refers to such arrangements as chains of leases.
- 5.2 In a chain of leases the basic concept is that the right to capital allowances will cascade down to the long funding lessee lowest down the chain. At its simplest, where there is a chain of leases that are viewed as long funding leases by each member of the chain, the right to capital allowances will cascade down to the lessee lowest down the chain.
- 5.3 The legal owner and head lessor will not be entitled to capital allowances by virtue of s.34A CAA. Where a lessor acquires an asset for another purpose and qualifies for capital allowances it will bring in a disposal value on granting a long funding lease (s.61(1)(ee) CAA). If the sub-lease is a finance lease the disposal value will be the net investment in the lease and if it is an operating lease it will be the market value of the asset (paragraphs 3.6 to 3.8).
- 5.4 Where a long funding lessee acquires an asset for the purpose of onward long funding leasing s.34A will also apply to deny capital allowances. If the long funding lessee is initially entitled to capital allowances but then enters into a long funding lease it will need to bring in an appropriate disposal value under s.61(1)(ee) CAA.
- 5.5 The long-funding sub-lessee will be entitled to capital allowances.
- 5.6 Although the right has cascaded down the chain, the sub-lessee will make an independent calculation of the capital allowances due to it.
- 5.7 Example 1 Alfred buys an aircraft for £100m and immediately leases it to Bill under a full payout finance lease for 25 years. Bill uses the aircraft for 5 years before leasing it to Clarence for 20 years under a full payout finance lease when its value is £90m.

Alfred cannot claim capital allowances.

Bill uses the asset in his non-leasing trade. Providing he is satisfied that Alfred has not claimed capital allowances he may treat the lease as a long funding lease and claim capital allowances on the present value of the minimum lease payments, as would be computed under generally accepted accounting practice (s.70C(5) CAA). This would probably be £100m.

Five years later, on granting the sub-lease, Bill records £90m as his net investment in the sub-lease and brings a disposal value of £90m into his capital allowance computation.

Providing Clarence is satisfied that Alfred and Bill have not claimed capital allowances (or, if they have, have brought in a disposal value) Clarence can claim capital allowances on the present value of the minimum lease payments, as computed under generally accepted accounting practice. This would probably be about £90m.

5.8 Example 2 Dennis leases an asset to Charlie. Charlie then leases the asset to Bernard who leases it to Ann.

If Dennis has claimed capital allowances and either –

- Dennis has not treated the lease to Charlie as a long funding lease which means that Dennis will not have brought a disposal value into account under s61(1)(ee), or
- Dennis has claimed an allowance other than a plant or machinery allowance

then nobody lower in the chain than Dennis can claim plant or machinery allowances.

If Dennis has treated the lease to Charlie as a long funding lease and has brought a disposal value into account Charlie can claim capital allowances if he has treated the lease to him as a long funding lease. If Charlie does not treat the lease to Bernard as a long funding lease Charlie will not have brought a disposal value into account and neither Bernard nor Ann can claim capital allowances.

If Dennis has treated the lease to Charlie as a long funding lease and Charlie has treated the lease to Bernard as a long funding lease but Bernard does not treat the lease to Ann as a long funding lease then Bernard can claim capital allowances but Ann cannot.

Ann cannot treat the lease as a long funding lease (and so claim plant or machinery allowances) unless –

- none of Dennis, Charlie and Bernard is entitled to capital allowances, and
- if any of Dennis, Charlie and Bernard has been entitled to capital allowances that person brought a disposal value to account under s61(1)(ee) CAA at or before the time the lease to Ann was granted.

6 TRANSFERS & ASSIGNMENTS ETC.

Introduction

- 6.1 Sections 70W and 70X CAA deal with the transfer of leased plant or machinery from one lessor to another, and one lessee to another, respectively. The transfer of a leased asset (together with the lease) usually involves the novation of the lease contract and so the creation of a new lease from the new lessor to the existing lessee (or from the existing lessor to the new lessee).
- 6.2 In broad terms, the effect of these sections is to allow the taxation of the old and new lessors (and lessees) to proceed independently whilst preserving the classification of the original lease as a long funding lease or otherwise, but only if the arrangements remain essentially the same apart from the change in lessor or lessee.

Transfers, assignments by lessor (s.70W CAA)

- 6.3 A lessor of plant or machinery may sell or otherwise transfer the plant or machinery to another person and at the same time the lease may be novated to the new lessor.

- 6.4 When this happens the old lessor is treated as if the lease terminated immediately before the transfer, even where this is not actually the case.

- 6.5 The new lessor is treated as if –

- a new lease had been entered into immediately after the transfer
- the new lease started on the transfer date, and
- the term of the new lease started on the transfer date.

- 6.6 Where –

- the term of the new lease is the unexpired portion of the term of the old lease, and
- the rents receivable under the new lease are the same as the rents that would have been receivable under the old lease,

the new lease is treated as a lease of the same type as the old lease. That is, where the old lease is not a long funding lease for the old lessor, then the new lease is not a long funding lease for the new lessor. And if the old lease is a long funding lease for the old lessor the new lease is a long funding lease for the new lessor.

- 6.7 Example: Jackson leases an asset to Kevin on a 20 year long funding lease. After 5 years when the lease still has 15 years to run Jackson transfers the asset and the lease to Lucy so Lucy becomes the lessor. The only change in the lease is the change in lessor and so the term of Lucy's lease to Kevin will be the unexpired portion of Jackson's lease to Kevin and the rents will be the same. Lucy is treated as if she had entered into a new long funding lease immediately after the transfer, as if that lease had started on the transfer date and as if the term of the new lease started on the transfer date.

- 6.8 The rules apply wherever there is the transfer of plant or machinery. The transfer of plant or machinery includes –
- (a) a disposal of the plant or machinery or of the lessor's interest in the plant or machinery;
 - (b) any arrangements under which the lessor's interest in the plant or machinery is terminated and another person becomes the lessor;
 - (c) where a person has been treated as the owner of a fixture by s.176 CAA, a cessation of that deemed ownership because -
 - the person ceases to have the qualifying interest,
 - a lessee is treated as the owner of the fixture,
 - the fixture is permanently severed from the relevant land,
 - the person is an equipment lessor and assigns their rights under the equipment lease or the financial obligations of the lessee are discharged, or
 - the person is an energy services provider and assigns their rights under the energy services agreement or the financial obligations of the client are discharged.
- 6.9 Section 70W only applies where the lessee remains the same. It does not apply where the lessor sells the asset to another person, and leases it back, thus allowing the original lease to remain in place. In these circumstances s.70Y applies, see paragraph 6.15.

Transfers, assignments by lessee (s.70X CAA)

- 6.10 Similar rules apply to transfers by lessees.
- 6.11 Where a lessee of an asset (the old lessee) transfers that asset to another person who becomes the lessee of the asset (the new lessee) the old lease is treated as terminating immediately before the transfer. If the lease has been treated as a long funding operating lease by the old lessee there will be a disposal event and the new lessee will be treated as incurring qualifying expenditure.
- 6.12 The new lessee is treated as if –
- a new lease of the same type as the old lease had been entered into immediately after the transfer
 - the new lease started at the transfer date, and
 - the term of the new lease started on the transfer date.
- 6.13 Where –
- the term of the new lease is the unexpired portion of the term of the old lease, and
 - the rents payable under the new lease are the same as the rents that would have been payable under the old lease,
- the new lease is treated as a lease of the same type (long funding lease or not) as the old lease.

- 6.14 The same rules about the meaning of the transfer of plant or machinery apply for the lessee as for the lessor.

Sale and leaseback, lease and leaseback (s.70Y CAA)

- 6.15 Where there is a sale and leaseback or a lease and leaseback and the lessee has leased the plant or machinery to another person under a long funding lease the leaseback is also a long funding lease for both parties.

- 6.16 If the plant or machinery is leased back indirectly all of the leases involved in the leaseback are long funding leases.

Example Mike owns a ship that he leases to Ken under a long funding lease. Mike then enters into a sale and leaseback of the ship with Charles. The leaseback from Charles is also a long funding lease.

If Charles leases the ship to Rob who then leases it back to Mike both Charles' lease to Rob and Rob's lease to Mike are long funding leases.

- 6.17 The rules about the meaning of the transfer of an asset that apply to transfers and assignments apply to sale and leasebacks and lease and leasebacks with one addition: the transfer of an asset also includes the grant of a lease.

7 COMMENCEMENT AND TRANSITION

Commencement

- 7.1 A lease may be a long funding lease if –
- it is finalised on or after 1 April 2006, or
 - the lease commences on or after that date
- and the lease is not an excepted lease (paragraph 7.7)
- 7.2 A lease may also be a long funding lease if the lease commences before 1 April 2006 but the plant or machinery is not brought into use until that date or later.
- 7.3 However, any lease that was finalised before 21 July 2005 will not be a long funding lease as long as the lessor was within the charge to tax on 17 May 2006. This means that for a lease finalised before 21 July 2005 at a time when the lessor was outside the charge to tax, the long funding lease legislation will apply if the lessor comes within the charge to tax after 16 May 2006.
- 7.4 For times before 16 May 2006 there is no requirement that the lessor is within the charge to tax. This means that if a lease was finalised before 21 July 2005 and the lessor came within the charge to tax before 16 May 2006 the long funding lease legislation does not apply whether or not the lessor was outside the charge to tax on 21 July 2005.
- 7.5 A lease may also be a long funding lease if the lessor makes an election under Regulations to be made under paragraph 16 of Schedule 8 (see Annex B).
- 7.6 Where a lease is not within the scope of Schedule 8 none of the provisions of Schedule 8 applies.

Excepted leases (paragraphs 17, 18 and 19, Schedule 8)

- 7.7 In broad terms, the concept of excepted leases allows a transitional period so that existing leases, and leases which were about to commence when the long funding lease regime was announced on 21 July 2005, are not affected by the introduction of the rules for taxing long funding leases.
- 7.8 A lease is an excepted lease if the following conditions are met.
- Condition 1: Before 21 July 2005 there was a pre-existing heads of agreement (paragraph 7.11).
 - Condition 2: The leased plant or machinery was under construction before 1 April 2006 (paragraph 7.32).
 - Condition 3: The lease is finalised (paragraph 7.40) before 1 April 2007 (or, if certain conditions are met, 1 April 2009 – see paragraph 7.9)
 - Condition 4: The commencement of the lease term (paragraph 2.43) is before 1 April 2007 (or, if certain conditions are met, 1 April 2009 – see paragraph 7.9).

- Condition 5: The lessee is the person identified as such in the pre-existing heads of agreement.
- Condition 6: The principal terms of the lease are not materially different from those in the pre-existing heads of agreement (paragraph 7.42).

7.9 The time limits in Conditions 3 and 4 may be extended to 1 April 2009 if the following conditions are met.

- Condition A: The lease term commences before 1 April 2009.
- Condition B: The lease term commences as soon as reasonably practicable after construction of the asset is substantially complete.
- Condition C: Construction has proceeded continuously from 1 April 2006.
- Condition D: Construction has proceeded at the normal pace for an asset of its type. For this purpose “normal pace” is the pace required to construct the asset in a reasonable time without delays or interruptions and consistent with normal business practice.

These conditions are unlikely to be met where the start of construction of the asset has been brought forward, but the delivery date has not.

7.10 Events beyond the control of the people involved may make it impossible to meet conditions B, C or D. An event is beyond the control of a person if the person could not foresee the event and could not have reasonably foreseen the event when the main contract for construction was entered into. For example, the ship carrying materials to be used in the construction of the asset may sink.

Pre-existing heads of agreement

Outline

7.11 A pre-existing heads of agreement is an agreement or common understanding that is evidenced in writing (paragraph 7.14) between the lessor’s side and the lessee’s side (paragraph 7.16)

7.12 The written evidence of agreement must include the principal terms of the proposed lease as defined in paragraph 27 of Schedule 8, namely–

- the identity of the lessee (paragraph 7.18)
- the identity or description of the asset to be leased (paragraph 7.20),
- particulars, or a description, of the rentals payable under the lease, and
- particulars, or a description, of the term of the lease.

7.13 See paragraph 7.24 where the agreement refers to two or more assets.

Written agreement

7.14 The pre-existing heads of agreement refers to an established commercial consensus that existed as at 20 July 2005 between the two principal parties to the proposed lease. Evidence to show this consensus must exist in writing made on or before 20 July 2005. The written agreement does not have to be

as formal as a signed term sheet and could be in the form of letters, emails or more formal documents.

- 7.15 The pre-existing heads of agreement does not have to be binding on either party, nor does it have to be a single document or be signed by lessor and lessee.

Lessee's side, lessor's side and lessee

- 7.16 The terms "lessee's side" is defined in paragraph 27 of Schedule 8 to mean:

- the lessee,
- a person who controls (or is to control) the lessee,
- any two or more persons who together control (or are to control) the lessee.

The "lessor's side" is defined in similar terms.

- 7.17 This means that there may be a pre-existing heads of agreement when neither the lessor nor the lessee yet exists.
- 7.18 However, the lessee must be identified precisely as a particular (unique) entity. A description such as "a wholly owned subsidiary of ..." does not by itself identify a particular lessee because there could be more than one wholly owned subsidiary.
- 7.19 The lessor does not have to be identified precisely. This means that a lessor group could set up or identify a special purpose vehicle to act as lessor subsequent to the pre-existing heads of agreement.

Description of asset

- 7.20 The pre-existing heads of agreement must include details of the asset to be leased. The requirement to describe the asset will be met if the existing agreement describes a type of asset in sufficient detail to identify it.
- 7.21 For example, the existing agreement might be an arrangement for financing all the fixtures in a building that is currently under construction or refurbishment. The requirement to describe the asset will be met if the fixtures are described in project documentation seen by the potential lessor.
- 7.22 Given that the fixtures in a building are unlikely to be a single asset, it is likely the conditions in paragraph 25 of Schedule 8 ("Combined assets and constituent assets") would also need to apply (paragraph 7.26).
- 7.23 In applying paragraph 25 of Schedule 8 to a building it may be necessary to consider whether one part of the building could be used without another part, particularly if the building is constructed or refurbished sequentially. For example, if a building is refurbished in two stages, one after the other, then it may be necessary to consider each stage separately.

Pre-existing heads of agreements relating to two or more assets

- 7.24 Paragraph 20 of Schedule 8 caters for pre-existing heads of agreement that relate to two or more assets.

- 7.25 Where the assets are to be used individually the principles in s.70M CAA are used to deem separate pre-existing heads of agreement. Each deemed pre-existing heads of agreement should be considered separately for the purpose of considering whether the transitional conditions are met.
- 7.26 Where the assets are to be used as part of a greater whole, that is they are constituents of a “combined asset”, the combined asset is to be treated as if it were a single asset for the purpose of determining whether the transitional provisions apply.
- 7.27 A combined asset is an asset that meets the following conditions (paragraph 25, Schedule 8):
- the asset is for use individually,
 - it consists of two or more items of plant or machinery (referred to as constituent assets),
 - each of the constituent assets is constructed to be used with the other constituent assets as part of the combined asset.
- 7.28 An asset that can be used individually is not a constituent asset just because it is one of a number of similar assets, the use of which is to be co-ordinated to any extent.
- 7.29 Example There is a pre-existing heads of agreement for four aircraft that are to be used to deliver a new service between London and New York. The aircraft could be used individually. The aircraft are not constituent assets of a combined asset, even though all four aircraft were intended to service the same route.
- 7.30 Example There is a pre-existing heads of agreement to construct two buildings adjacent to each other and intended to form part of the same substantial development. The two buildings would not constitute a combined asset unless one could not realistically be used without the other. The mere fact, for example, that they shared a common air conditioning plant would not make the buildings a combined asset.
- 7.31 In contrast, the fixtures (such as lifts, heating and air conditioning) in each building are likely be a combined asset because it is unlikely that any one asset would be of any use without the others.

Under construction

- 7.32 The term “under construction” is defined at paragraph 24 of Schedule 8.
- 7.33 An asset is under construction at in time in the period that begins when construction of the asset begins and ends when construction is complete. If an asset consists of two or more component parts it is under construction after the start of construction of any component part that was identified as a component part before construction of that part begins.
- 7.34 A leased asset is not under construction at any time after commencement of the term of the lease.

- 7.35 The word “construction” takes its ordinary meaning, that is, in essence, “to put together the parts of” or “to make”. Therefore the concept of “under construction” does not extend to cover the design phase.
- 7.36 The start of construction of a component destined for a particular asset might constitute construction of the asset although the start of construction of a component that could fit into a number of different assets would not. The construction of a large component (such as the wing of an aircraft) is more likely to be viewed as the start of construction of “the asset”, than is the construction of a minor component such as seats or instrumentation. The facts would need to be examined to see whether in a particular case the asset was under construction or not.
- 7.37 In constructing a ship, for example, it may be necessary to begin construction of the propulsion system well before beginning to construct the hull. This may be because it takes a long time to construct the propulsion system, and it has to be ready to install in the hull by a particular date.
- 7.38 As long as the propulsion system is identified with a particular ship, the start of the construction of the propulsion system is the start of construction of the ship. This assumes, of course, that the propulsion system is the first component to be constructed. This contrasts with the situation where construction of (say) a marine turbine is started which is suitable for use in a number of vessels and has not been designated for use in a particular ship.

Construction of software

- 7.39 Software is not constructed in the same way as physical assets, but the same principles apply as for any other asset.

Finalised lease

- 7.40 A lease is finalised when all the following conditions are met –
- there is a contract in writing for the lease between the lessor and the lessee;
 - either (a) the contract is unconditional, or (b) if it is conditional, the conditions have been met;
 - no terms remain to be agreed.

See paragraph 23, Schedule 8.

- 7.41 A contract is unconditional if there are no events that must occur or conditions to be satisfied before the parties become bound by the contract. When all the events occur or the conditions are satisfied the contract becomes unconditional at that point.

Lease not materially different from the pre-existing heads of agreement

- 7.42 If a lease is to be an excepted lease, the principal terms of the lease (paragraph 7.12) must not be materially different from those in the pre-existing heads of agreement.
- 7.43 No change in lessee is allowed by Condition 5 (paragraph 7.8).

- 7.44 A minor change in the specification of an asset would not constitute a material difference. A change in type of asset, for example, from one type of aircraft to another, would constitute a material difference unless the two types of aircraft were so similar as not to be materially different.
- 7.45 A change in the rentals that reflects an increase in construction costs from estimates made at the date of the pre-existing heads of agreement is unlikely to make the final lease materially different from the existing agreement.
- 7.46 In contrast, if the increase in costs reflects a change in the nature of the assets to be leased then there might be a material difference from the existing agreement. It would depend on the details of the particular case, particularly the degree to which the assets that are finally leased are different from those described in the existing agreement.
- 7.47 It is, however, the final lease, taken as a whole, that must not be materially different from the existing agreement for the transitional rules to apply. All the facts would need to be taken into account before coming to a final decision.

Expenditure incurred before 19 July 2006

- 7.48 A lessor may incur expenditure on the provision of plant or machinery for leasing under a long funding lease before the Finance Act 2006 received Royal Assent on 19 July 2006 and yet the lease may not be an excepted lease.
- 7.49 If the lease is not an excepted lease and there was a pre-existing heads of agreement for that long funding lease before 21 July 2005, the expenditure is split into two parts. The first part is expenditure incurred before 19 July 2006 and the other part expenditure incurred on or after that date.
- 7.50 The two parts are treated as if they had been incurred on providing separate assets.
- 7.51 The part relating to expenditure incurred before 19 July 2006 is treated as expenditure on an asset that is subject to an excepted lease and so the long funding lease legislation does not apply to it.
- 7.52 The other part is treated as if it had been incurred on an asset for leasing under a long funding lease to which the long funding lease legislation applies.
- 7.53 The rentals attributable to each asset are to be determined on a just and reasonable basis.
- 7.54 As a general rule, paragraph 22 of Schedule 8 provides that the normal rules about when expenditure is incurred apply.
- 7.55 There may have been attempts to avoid the introduction of the rules for long funding leases by varying the terms of an agreement so that an obligation to pay which would have become unconditional on or after 19 July 2006 becomes unconditional before that date. If it were effective this would have the effect of treating the expenditure as relating to an asset that was to be subject to an excepted lease.

7.56 It is our view that such a variation would not have that effect but this was put beyond doubt by an announcement on 22 March 2006. As a result, where the variation takes place on or after 22 March 2006 paragraph 22(7) of Schedule 8 ensures that the expenditure is incurred on the date on which it would have been treated as incurred before the variation.

8 AVOIDANCE

Avoidance involving international leasing (s. 70V CAA)

8.1 Cross-border structures might be created solely or mainly for the purpose of extracting value from the capital allowances available on the plant or machinery.

8.2 Example:

- P Ltd is the owner and head lessor of an aircraft. P Ltd is not resident in the UK, and not liable to tax in the UK,
- P Ltd leases the aircraft to Q Ltd, a UK resident. The terms of the lease are such that the present value of the minimum lease rentals is 81% of the fair value of the aircraft. From Q Ltd's perspective the lease is a long funding lease and so it is able to claim capital allowances under s.70A CAA.
- Q Ltd leases the aircraft to R Ltd who is not resident in the UK, and not liable to tax in the UK. The present value of the rentals is less than 80% of fair value of the aircraft. The lease is not a long funding lease.
- in the absence of s.70V, Q Ltd would retain the right to capital allowances (which would be lost if the lease to R Ltd was a long funding lease).

The value of the capital allowances to Q Ltd more than makes up for the fact that the rents receivable under the lease out of the UK may be less than rents payable under the long funding lease. The net effect of the arrangements is to pass most of the tax benefits arising from the availability of capital allowances to R Ltd, the non-resident. Q Ltd has little or no other function in the arrangements.

8.3 A similar arrangement could be constructed where Q Ltd is entitled to capital allowances under s.67 CAA.

8.4 Section 70V applies where –

- a non-resident leases plant or machinery directly or indirectly to a resident,
- the lease to the resident is a long funding lease or one to which s.67 CAA applies,
- the plant or machinery is leased onwards by the non-resident under a lease which is not a long funding lease, and the lessee under that lease (or any sub-lease) is not resident in the UK, and
- the sole or main purpose of the arrangements is to allow the UK resident to obtain plant and machinery allowances.

8.5 Where these conditions are met, the onward lease from the UK resident is treated as a long funding lease. This means that the UK resident is not entitled to claim capital allowances but will be taxed as if both leases were financing transactions.

- 8.6 For the purpose of s.70V –
- a non-resident is defined as a person not resident in the UK who leases an asset that it does not use exclusively for earning profits chargeable to tax to another person;
 - a resident is a person resident in the UK who leases an asset that it uses exclusively for earning profits chargeable to tax.
- 8.7 Section 70V is unlikely to affect businesses leasing assets into the UK where the lease out of the UK was for a far shorter period than the lease into the UK.
- 8.8 For example it would not affect a UK business that leases an aircraft into the UK on a 20-year lease and expects to lease it out of the UK in the course of that business to a succession of users on independent leases of, say, 5 years.

9 CHARGEABLE GAINS

- 9.1 Paragraphs 4 and 5 of Schedule 9 add sections 25A and 41A to the Taxation of Chargeable Gains Act 1992 ("TCGA"). These new sections contain rules governing the computation of the capital gains or losses arising from plant or machinery leased under a long funding lease.

Deemed disposals and reacquisitions when plant or machinery used for long funding lease (s.25A TCGA)

- 9.2 When plant or machinery is leased out under a long funding lease, all profits and losses arising under the lease are dealt with under the rules for taxing long funding leases in Schedule 8. This includes any profits or losses that would otherwise fall to be dealt with under the chargeable gains regime.
- 9.3 When plant or machinery is used for long funding leasing, s.25A TCGA deems the asset to have been disposed of and immediately reacquired at both the start and end of the lease. The disposal and reacquisition values at the start and end of the lease tie in with those used in Schedule 8 for income (rather than chargeable gains) purposes.
- 9.4 The disposal and reacquisition value at the start of the lease (s.25A(4)) is –
- if the lease is a long funding finance lease, the lessor's net investment in the lease.
 - if the lease is a long funding operating lease, the asset's market value at the commencement of the lease term.

These amounts are the same as those used for capital allowance purposes in items 5A and 5B of the table in s.61(2) CAA (paragraph 3.7).

- 9.5 The disposal and reacquisition value at the end of the lease is the termination amount as defined in s.70YG CAA (s.25A(3)).
- 9.6 One effect of s.25A is to crystallise any gain (or loss) that may have accrued before the start of the lease. The amount of that gain (or loss) is established in the normal way but on the assumption the asset was disposed of for the amounts mentioned in paragraph 9.4.
- 9.7 The deemed disposal is to a deemed counter-party. That counter-party is not deemed to be a connected person and so sections 18(3) and 171 TCGA do not apply to a deemed disposal under s.25A.
- 9.8 Capital allowances are not available on the plant or machinery whilst it is used for long funding leasing and so any increase or fall in value over the term of the lease does not give rise to a chargeable gain or allowable loss.
- 9.9 Example In 2007, George acquires a satellite for £100m. The satellite is successfully launched and used for two years at which point it has a market value of £150m. George leases the satellite under a long funding finance lease to Harry and records a net investment in the lease of £150m.

Initially, George claims capital allowances on the £100m cost. When the satellite is leased he brings in a disposal value of £100m as the £150m is limited to cost by s.62 CAA.

For chargeable gains purposes the satellite is deemed to be disposed of for £150m and the chargeable gain is computed in the usual way.

Five years later the satellite has a market value of only £80m and Harry no longer wants to use it. George agrees to terminate the lease early when his net investment in the lease is £130m but the satellite is only worth £80m.

Harry pays George £70m, being the difference between George's net investment in the lease and market value.

For chargeable gains purposes, George is treated as disposing of and reacquiring the asset for £80m (the termination amount given by s.70YG CAA).

Lessor that is itself a lessee

- 9.10 A lessor may be a lessee. However, where a lessee grants a long funding sub-lease s.25A will not give rise to a chargeable gain or allowable loss on granting the lease.

Restriction of losses – fixtures (s.41A TCGA)

- 9.11 Where plant or machinery is leased under a lease that is not a long funding lease, s.41 TCGA restricts any loss on disposal to the extent that relief is given by way of capital allowances.
- 9.12 Capital allowances are not available to a lessor where the plant or machinery is leased under a long funding lease and where the plant or machinery is the asset for the purposes of TCGA then s.25A TCGA will apply.
- 9.13 However, further rules are needed where the plant or machinery is a fixture. Section 41A TCGA applies where a person disposes of an asset that includes plant or machinery which is a fixture that has been leased under a long funding lease.
- 9.14 For the purposes of TCGA the chargeable gain or allowable loss on disposal of an asset such as building is computed on the basis that the asset is the building. When a building has been leased out so that there is a derived long funding lease of fixtures that are plant or machinery s.41A restricts any loss arising.
- 9.15 The amount of the restriction is the amount by which the value of the plant or machinery has fallen during the period of the lease.
- 9.16 Example A building costs £6m, of which £2m refers to fixtures. The building is leased out under a long funding lease for 20 years. At the end of those 20 years, the building is sold for its then market value of £2m, of which £0.5m refers to the fixtures.

Without taking s.41A into account there would be a loss of £4m.

However, as the reduction in value of the fixtures over the period for which they are leased is £1.5m, in computing the gain or loss the cost of the building is reduced by £1.5m to £4.5m. The loss is reduced to £2.5m.

Definition of market value

- 9.17 Paragraph 6 of Schedule 8 amends section 272 TCGA so that the general definition of market value is specifically overridden by the definitions in section 25A and section 41A.

10 TONNAGE TAX

Outline

- 10.1 Paragraph 10 of Schedule 9 introduces paragraphs 91A to 91F into the tonnage tax rules in Schedule 22, FA 2000.
- 10.2 Paragraphs 91A to 91F apply to leases of qualifying ships to tonnage tax companies. They treat leases that would otherwise be long funding leases as not being long funding leases.
- 10.3 Where the lease is finalised (paragraph 7.40 above) before 1 April 2006, a lease of a qualifying ship is not a long funding lease if –
- the ship is leased directly to a tonnage tax company, or
 - the ship is leased indirectly to a tonnage tax company, and there is only one intermediate lessor between the head lessor and the tonnage tax company, and that intermediate lessor is a member of the same group as the tonnage tax company (paragraph 10.6).
- 10.4 Where a lease is finalised on or after 1 April 2006, it is not a long funding lease if –
- it meets the conditions in paragraph 10.3, and
 - the tonnage tax company operates and manages the ship as described in paragraph 10.7 below, and
 - where the tonnage tax company leases the ship out of tonnage tax it meets the conditions on period and rate of sublease described in paragraph 10.12 below.
- 10.5 These conditions must be met, or be expected to be met, when the qualifying ship is first brought into use under the lease (paragraph 91A(2) of Schedule 22).

Lease to tonnage tax company or group (paragraph 91B, Schedule 22)

- 10.6 A lease only meets the condition in paragraph 91B in two circumstances. Either –
- the lease must be a lease of a qualifying ship provided directly by the lessor to a company within tonnage tax, or
 - the lease must be a lease of a qualifying ship provided directly to a member of the tonnage tax company's group (as defined in paragraph 116 of Schedule 22). That group member must then lease the ship directly to the tonnage tax company. That is, if there is a chain of leases with lessor A leasing to company B who leases to tonnage tax company C, then B must be a member of C's group.

Requirement to operate and manage the ship (paragraph 91C, Schedule 22)

- 10.7 A lease of a qualifying ship provided, directly or indirectly, to a company within tonnage tax falls within paragraph 91C if the tonnage tax company is responsible –

- for the operation of the ship, including the appointment of the master and those members of the crew engaged in navigation, and
- for defraying all expenses in connection with the ship, or substantially all such expenses other than those directly incidental to a particular voyage or to the employment of the ship during any period for which the ship is leased by the tonnage tax company to another person.

10.8 For this purpose, the tonnage tax company is "responsible" if –

- it is responsible as principal, or
- it appoints another person to be responsible in his place and that other person
 - is not a person to whom the ship is leased by the tonnage tax company and is not connected with such a person, or
 - is a company within tonnage tax.

10.9 Where a person is appointed as agent to act for the tonnage tax company and is responsible for defraying expenses, the tonnage tax company is no longer "responsible" within the meaning of paragraph 91C, even if the tonnage tax company is required to reimburse the agent.

10.10 For the purpose of this test, a lease by the tonnage tax company includes a contract of affreightment entered into by the tonnage tax company that provides for the carriage of goods by the qualifying ship.

10.11 A ship might be "leased" under a contract of affreightment when, for example, a bulk carrier is contracted to carry goods from one port to another. In contrast, in our view, where the tonnage tax company enters into contracts of affreightment to unconnected parties for individual container slots the ship is not being leased to another person.

Limit on length of charters etc out of tonnage tax (paragraph 91D, Schedule 22)

10.12 The conditions mentioned in paragraph 10.4 only apply if the lease is to a company that is not within tonnage tax. And where that is the case (and the other conditions are met) the lease will not be a long funding lease if –

- the amount payable under the sublease is at the market rate, and
- the period of the sublease is no more than 7 years (but see paragraph 10.13).

10.13 For this purpose –

- the period of the sublease includes any period covered by an option to extend the original term unless the rent payable from the beginning of that further period is the market rate then current for such a lease, in which case the further period is ignored;
- the market rate is the rate at which the qualifying ship could be leased, taking into account all the circumstances of the lease including the period of the lease, the date at which the lease commences and the size and description of the qualifying ship;
- lease includes a charter or contract of affreightment.

10.14 Example In January 2007, TT Ltd, a tonnage tax company, leases a 4000 TEU container ship directly from Baretshire Bank for 20 years under a full payout finance lease. TT Ltd is responsible for operating and managing the ship.

Also in January 2007, TT Ltd enters into a 6-year time charter with NTT Inc a company that is not in tonnage tax. The charter rate is the market rate for a 6-year charter of a 4000 TEU container ship as at January 2007. NTT Inc has the option to extend the time charter for a further 5 years from January 2012, but only on the basis that the charter rate for those 5 years is the market rate for a 5-year charter of a 4000 TEU container ship as at January 2012.

The lease from Baretshire Bank to TT Ltd is not a long funding lease.

Anti-avoidance (paragraph 91E, Schedule 22)

10.15 Paragraph 9 also introduces a new anti-avoidance rule into the tonnage tax regime.

10.16 The rule, which is in paragraph 91E of Schedule 22, will bite if the main purpose, or one of the main purposes, of leasing a ship, or of a series of transactions of which leasing the ship is one, or of any of the transactions in such a series was to avoid the effect of the provisions in paragraphs 90, 92, and 94 to 102 of Schedule 22. Those provisions limit the amount of expenditure on a ship which can qualify for capital allowances.

10.17 Where paragraph 91E applies, the lease will not be protected by paragraph 91A and so will be a long funding lease if it meets the conditions in s.70G CAA.

11 OTHER CHANGES MADE BY SCHEDULES 8 & 9

Fixtures

- 11.1 Paragraph 9 of Schedule 8 introduces s.172A CAA.
- 11.2 Section 172A disapplies the fixtures legislation in Chapter 14 CAA when the plant or machinery in question is subject to a long funding lease.
- 11.3 The legislation is also disapplied where the condition in paragraph 11.2 is met and the lessee under that long funding lease becomes the lessor of some or all of the leased plant or machinery under a further lease which is not itself a long funding lease. That is, Chapter 14 is also disapplied where the original lessee enters into a lease which is not a long funding lease.
- 11.4 The effect of this is that the allowances for expenditure on fixtures available to lessors and lessees under long funding leases, and associated sub-leases, are to be determined under the rules applicable to long funding leases, rather than the rules that would otherwise apply to fixtures.
- 11.5 Section 172A also provides that Chapter 14 is not to apply to determine ownership.
- 11.6 Example In 2008, Barsetshire Bank buys plant costing £10m, and leases it to WidgetCo Ltd under a long funding lease. WidgetCo Ltd takes delivery of the plant and installs it in its factory in such a way that the plant becomes a fixture.

Prior to the enactment of s.172 A, and subject to certain conditions, particularly the need for lessor and lessee to make a joint election under s.177(4), Chapter 14 could have operated to allow Barsetshire Bank to be treated as owning the plant. However, as s.172A applies, Chapter 14 will not apply to the lease and the normal rules that apply to long funding leases will treat WidgetCo Ltd as owning the plant and being entitled to capital allowances.

- 11.7 Example Angela owns the freehold of a property that contains plant that is not background plant or machinery. In 2008, the property is leased to Beth for 25 years, and in 2010 it is sub-leased to Caroline for 10 years. The lease from Angela to Beth gives rise to a derived long funding lease under s.70L CAA, but that the lease from Beth to Caroline does not.

The effect of s.172A is to give Beth the right to capital allowances on the derived lease of plant. No election could be made under Chapter 14. Although lease from Beth to Caroline is not a long funding lease no election can be made under Chapter 14 even if the conditions for making an election are otherwise met.

Oil extraction activities

- 11.8 Paragraph 1 of Schedule 9 amends the definition of finance costs in s.494AA (petroleum extraction activities: sale and leaseback). The definition now includes, in the case of long funding operating leases, the rentals net of the reduction made under s.502K.

11.9 Paragraph 2 makes a similar amendment to the definition of finance costs in s.501A ICTA (supplementary charge in respect of ring fence trades).

Anti-avoidance – amendments to existing rules

11.10 Paragraph 3 of Schedule 9 amends the anti-avoidance rules in s.782 ICTA so they will not apply to long funding leases.

11.11 Paragraph 6 makes a similar amendment to the anti-avoidance rules in Schedule 12 FA 1997.

11.12 Paragraph 13 makes a similar amendment to the anti-avoidance rules in s.219 CAA.

First year allowances

11.13 Paragraph 11 of Schedule 9 amends s.46 CAA so that first year allowances are no longer available to lessors except for –

- cars with low carbon dioxide emissions, and
- plant or machinery leased with a building where it functions as background plant or machinery.

11.14 This change applies to expenditure incurred on or after 1 April 2006.

Hire purchase etc

11.15 Paragraph 12 of Schedule 9 amends the hire purchase rules in s.67 CAA so that –

- hire purchase transactions with overseas lessees are treated in the same way as transactions with UK lessees,
- the rules only apply to a lessee if the lease should be accounted for as a finance lease under generally accepted accounting principles, and
- the hire purchase rules apply equally to alternative hire purchase arrangements, for example those developed to be Shari'a compliant.

11.16 These changes apply to contracts finalised on or after 1 April 2006.

Transactions with overseas lessees

11.17 Prior to FA 06, s.67 applies where the lessee (the person acquiring the asset under the hire purchase contract) carries on a qualifying activity.

11.18 Paragraph 12 of Schedule 9 amends s.67 so that it also applies where the lessee carries on an activity that would be a qualifying activity were it carried on by a person resident in the UK.

Requirement for lessee to account for lease as a finance lease

11.19 Under a standard hire purchase contract the lessee (purchaser) makes regular payments over the term of hire and acquires ownership on making the last payment or by exercising an option to acquire the asset at the end of the period of hire.

- 11.20 Such arrangements should be accounted for as finance leases and where this is the case subsections (2B) and (2C), which are introduced by FA2006, have no effect.
- 11.21 Subsection (2)(B) means that where the lessee accounts for the lease as an operating lease (or would do so if accounts were prepared under generally accepted accounting practice) the lessee is not treated as owning the asset and so capital allowances are not available on capital payments.
- 11.22 Unless they are identifiable as capital, payments under operating leases are regarded as being on revenue account and so relief for payments under the lease should normally be available as a revenue expense of the payer (an exception being where there is a restriction under s.578A ICTA (expensive car hire)).
- 11.23 Subsection (2)(C) means that where the lessee is not treated as the owner only because the lease is accounted for as an operating lease by the lessee, the lessor cannot be treated as the owner.
- 11.24 Example A lessor buys an aircraft for £50m. An airline enters into a lease of an aircraft with a lessor operating overseas. The lease requires the airline to pay £100,000 on signing the lease and then pay £4m a year for three years. The contract contains an option for the airline to buy the aircraft for £44.9m, which is its then expected market value of £45m less the £100,000 paid on signing the lease.

The contract is drafted so that the £100,000 is capital expenditure on the provision of plant or machinery and, as the lessee might acquire the asset, s.67 allowed the airline to claim capital allowances on £50m. The lease is correctly accounted for as an operating lease under generally accepted accounting practice.

The effect of s.67(2B) is to deny capital allowances on the capital expenditure incurred, and potentially to be incurred, by the lessee. The lease rentals of £4m a year would be allowable as a revenue expense, as normal. If the airline exercised the option to acquire the asset it would become the owner and capital allowances would be due on the £44.9m.

Alternative hire purchase arrangements

- 11.25 A typical hire purchase contract contains the option to purchase the asset in the same contract as the contract for hire.
- 11.26 Some alternative financing arrangements involve –
- an agreement to lease (or hire) the asset, and
 - a separate agreement or undertaking as a result of which the lessee may acquire the asset. For this purpose, an undertaking includes a promise that does not amount to a contract and which may not be legally enforceable.
- 11.27 If these agreements, when taken together, would mean that the lessee incurs capital expenditure on the provision of plant or machinery and shall or may become the owner of the plant or machinery on the performance of the contract, then the agreements are treated as though they are a single contract for the purpose of s.67.

Overseas leasing

- 11.28 Paragraph 13 of Schedule 9 introduces a new subsection (2A) into s.105 CAA.
- 11.29 This new subsection provides that no account shall be taken of any lease finalised (paragraph 7.40) on or after 1st April 2006 in determining whether plant or machinery is used for overseas leasing.
- 11.30 This means that where plant or machinery is first leased to an overseas lessee on or after 1 April 2006, the lessor's right to capital allowances will not be restricted under Chapter 11 of Part 2 CAA.
- 11.31 Example In 2002 Bassetshire Bank leased a ship to UKS Ltd, a shipping company that traded in, and was resident in, the UK. In 2007, UKS Ltd leases the ship for 15 years to PSCo, a shipping company resident in, and trading from, Panama.
- The lease from UKS Ltd to PSCo does not lead to the ship being regarded as used for overseas leasing. Bassetshire Bank retains the right to capital allowances.
- 11.32 Example A leased ship has been treated as subject to the overseas leasing rules and the qualifying expenditure has been included in the overseas leasing pool and capital allowances claimed at a rate of 10%. A new lease is finalised in respect of that ship after 1 April 2006.
- Capital allowances remain due at 10%.

Allocation rules

- 11.33 Where a lessor incurs capital expenditure on plant or machinery for leasing under a finance lease the amount on which capital allowances are available is restricted by s.220 CAA in the period in which the leased asset was acquired.
- 11.34 Where the expenditure is incurred on or after 1 April 2006 –
- s.220 only applies to companies,
 - s.220 only applies where a lessor company does not use the group's normal accounting date, but
 - s.220 applies to plant and machinery leased under an operating lease where:
 - (a) the lease is a funding lease, and
 - (b) the lease term is for more than 4 years and not more than 5 years.
- 11.35 Annex C contains a flow chart illustrating the effect of s.220 as amended by Schedule 9.

CONTACT POINT

Enquiries relating to, and comments on, this Technical Note should be addressed to:

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ANNEX A – BACKGROUND PLANT OR MACHINERY

- A.1. The basic definition of background plant or machinery is contained in s.70R(4) CAA.
- A.2. It is proposed that this definition will be supplemented by Regulations to be made under the powers given by s.70T CAA.
- A.3. A draft of the Regulations is on the following pages. It is proposed that the Regulations will be made in the autumn of 2006.
- A.4. Comments on this draft are welcome and should be made by 29 September 2006. Comments should be addressed to the contact point given at the end of this note.

2006 No.

INCOME TAX

CORPORATION TAX

The Capital Allowances (Leases of Background Plant or Machinery for a Building) Order 2006

<i>Made</i> - - - -	***
<i>Laid before the House of Commons</i>	***
<i>Coming into force</i> - -	***

The Treasury make the following Order in exercise of the powers conferred upon them by section 70T(2) of the Capital Allowances Act 2001 (a):

Citation, commencement and effect

1.—(1) This Order may be cited as the Capital Allowances (Leases of Background Plant or Machinery for a Building) Order 2006 and comes into force on [] 2006.

(2) This Order has effect in relation to times on and after 1st April 2006.

Examples of background plant or machinery

2.—(1) The following prescribed descriptions of plant or machinery are examples of the kinds of plant or machinery that may be regarded as falling within the definition of background plant or machinery in determining whether any particular plant or machinery does or does not fall within that definition.

(2) The prescribed descriptions of plant or machinery are—

- (a) heating and air conditioning installations,
- (b) ceilings which are part of an air conditioning system,
- (c) hot water installations,
- (d) electrical installations that provide power to a building, such as high and low voltage switchgear, all sub-mains distribution systems and standby generators,
- (e) mechanisms, including automatic control systems, for opening and closing doors, windows and vents,

(a) 2001 c. 2. Section 70T was inserted by paragraph 7 of Schedule 8 to the Finance Act 2006 (c.).

- (f) passenger lifts,
- (g) window cleaning installations,
- (h) fittings such as fitted cupboards, blinds, curtains and associated mechanical equipment,
- (i) carpets and other floor coverings,
- (j) demountable partitions,
- (k) protective installations such as lightning protection, wet/dry risers, hose reels, sprinkler/special installations, fire fighting appliances, smoke and similar detection installations, fire alarm systems including audio systems and sprinkler heads and fire escapes,
- (l) building management systems.

Plant or machinery deemed to be background plant or machinery

3.—(1) The following prescribed descriptions of plant or machinery are deemed to be background plant or machinery.

(2) The prescribed descriptions of plant or machinery are—

- (a) lighting installations including all fixed light fittings and emergency lighting systems,
- (b) telephone, audio visual and data installations incidental to the occupation of the building,
- (c) computer networking facilities incidental to the occupation of the building,
- (d) sanitary appliances and other bathroom fittings including hand driers, counters, partitions, mirrors, shower and locker facilities,
- (e) kitchen and catering facilities for producing and storing food and drink for the occupants of the building,
- (f) fixed seating,
- (g) signs,
- (h) public address systems,
- (i) intruder alarm systems and other security equipment including surveillance equipment.

Plant or machinery deemed not to be background plant or machinery

4.—(1) The following prescribed descriptions of plant or machinery are deemed not to be background plant or machinery.

(2) The prescribed descriptions of plant or machinery are—

- (a) plant or machinery used for the purpose of storing, moving or displaying goods to be sold in the course of a trade, whether wholesale or retail,
- (b) plant or machinery used for the purpose of manufacturing goods or materials,
- (c) plant or machinery used for the purpose of subjecting goods or materials to a process,
- (d) plant or machinery used for the purpose of storing goods or materials—
 - (i) which are to be used in the manufacture of other goods or materials,
 - (ii) which are to be subjected, in the course of a trade, to a process,
- (iii) which, having been manufactured or produced or subjected in the course of a trade to a process, have not yet been delivered to any purchaser, or
- (iv) on their arrival in the United Kingdom from a place outside the United Kingdom.

Date

Two of the Lords Commissioners of Her Majesty's Treasury

EXPLANATORY NOTE

(This note is not part of the Order)

The Finance Act 2006 (c.) amended the Capital Allowances Act 2001 (c. 2) to introduce new provisions in relation to long funding leases of plant or machinery. Leases of background plant or machinery are excluded from these provisions. This Order prescribes descriptions of plant or machinery to be used as examples of the kinds of plant or machinery that may be regarded as falling within the definition of background plant or machinery and deems other descriptions of plant or machinery to be, or not to be, background plant or machinery.

This Order has effect from 1st April 2006, authority for the retrospective effect is given by section 70T(4) of the Capital Allowances Act 2001.

ANNEX B – ELECTION TO TREAT LEASES AS LONG FUNDING LEASES

- B.1. An election for leases of plant or machinery to be treated as long funding leases may be made once the Treasury has made Regulations under the power conferred on them by paragraph 16 of Schedule 8 FA 2006.
- B.2. It is proposed that the Regulations will be made in the autumn of 2006.
- B.3. A draft of the proposed Regulations is on page 61. This draft is closely based on the details included with the Technical Note on Leased Plant and Machinery dated 31 March 2006.
- B.4. The scope of the election has, however, been expanded to allow certain leases of plant or machinery that is not new to fall within the scope of an election. This is achieved by allowing plant or machinery that is the subject of a valid election under s.227 CAA to fall within the scope of the election (Regulation 3, Condition D, paragraph (c)).
- B.5. In broad terms, an election under s.227 allows a person to acquire a new asset and, within 4 months, sell it and finance lease it back without triggering the anti-avoidance provisions in s.218 and s.224 CAA (restriction on the buyer's qualifying expenditure). The election under s.227 also prevents the seller claiming capital allowances.
- B.6. The intention here is to use the election under s.227 to allow certain nearly new (but strictly second hand) assets to be acquired by a lessor and yet fall within the scope of the election to treat the lease as a long funding lease. It is intended that using s.227 achieves two things:
- the first is to identify assets that were new when acquired by the seller and no more than 4 months old when acquired by the lessor for finance leasing back to the seller (or to a connected party).
 - the second is to ensure that the seller has not, and will not, claim capital allowances.
- In broad terms, the effect is that the seller's ownership is ignored for capital allowance purposes and the asset is treated as if it had been acquired new by the lessor.
- B.7. A draft of the guidance is on page 64. The guidance is necessarily in draft as the Regulations have yet to be made. This draft guidance also gives details of what will be required if an operating lessor wishes to be taxed on figures that appear in its accounts.
- B.8. We welcome comments on the draft Regulations (particularly on the use of s.227), and guidance (particularly on following accounts for operating lessors). We would also appreciate comments if particular commercial situations are not clearly covered by these draft Regulations and guidance.
- B.9. Comments should be made by 29 September 2006 to the contact point given at the end of this note.

STATUTORY INSTRUMENTS

2006 No.

CORPORATION TAX

INCOME TAX

The Long Funding Leases (Elections) Regulations 2006

<i>Made</i>	- - - -	***
<i>Laid before the House of Commons</i>		***
<i>Coming into force</i>	- -	***

The Treasury make the following Regulations in exercise of the power conferred upon them by paragraph 16 of Schedule 8 to the Finance Act 2006(a):

Citation, commencement and interpretation

1.—(1) These Regulations may be cited as the Long Funding Leases (Elections) Regulations 2006 and shall come into force on

(2) In these Regulations—

“CAA” means the Capital Allowances Act 2001(b);

“TMA” means the Taxes Management Act 1970(c).

Election

2.—(1) A lessor may make an election (“a long funding lease election”) in respect of a lease which falls within regulation 3 (“an eligible lease”).

The lessor who makes the election is referred to in these Regulations as the electing lessor.

For the purposes of these Regulations “lessor” has the meaning given in section 70YI of the CAA(d).

(2) The election must be given by notice in writing (“a long funding lease notice”) to an officer of Her Majesty’s Revenue and Customs.

(3) The long funding lease notice must specify—

- (a) the name and tax reference of the electing lessor, and
- (b) the date from which it is to be effective.

(4) The long funding lease notice must be signed by—

- (a) in the case of a sole trader, the person required to make a return for the business;

(a) 2006 c. 25
(b) 2001 c. 2
(c) 1970 c. 9.
(d) Sections 70A to 70YJ were inserted by paragraph 6 and 7 of Schedule 8 to the Finance Act 2006.

- (b) in the case of a partnership, the partner required to make a return under section 12AA(2) of TMA; or
- (c) in the case of a company, the proper officer of the company as determined by section 109(3) TMA.

Eligible leases

3. — An eligible lease is one which meets the following conditions.

Condition A

The lease is a plant or machinery lease as defined in section 70K of the CAA.

Condition B

The lease is not, apart from the provisions of these Regulations, a long funding lease as defined in section 70G of the CAA.

Condition C

The lease was finalised, as defined in paragraph 23 of Schedule 8 of the Finance Act 2006, on or after 1 April 2006.

Condition D

The plant or machinery made available under the lease was either—

- (a) unused and not second-hand at the commencement of the term of the lease, or
- (b) leased out under a long funding lease (under the provisions of part 2 of the CAA or pursuant to these Regulations) before the commencement of the term of the lease, or
- (c) the subject of a valid election under section 227 of the CAA made before the electing lessor makes a return for the period in which the commencement of the term of the lease took place.

For the purposes of this regulation the term “commencement of the term of the lease” shall be construed in accordance with section 70YI of the CAA.

Condition E

The lease is not a lease for the provision of a car as defined in section 81 of the CAA.

Condition F

The lease does not provide for the leasing out of any asset which is valued at more than £10 million at the commencement of the term of the lease.

Condition G

The term of the lease, as defined in section 70YF of the CAA, is for 12 months or more.

Condition H

The lease is not a lease of background plant and machinery as defined in section 70R of the CAA or a lease of plant or machinery leased with land as defined in section 70U of the CAA.

Commencement date and time limits for making an election

4.—(1) A long funding lease election may take effect from 1 April 2006 or any later date specified in the notice, subject to the time limits set out below.

(2) A long funding lease notice must be given—

- (a) for income tax purposes, within 12 months from the 31st January next following the year of assessment to which the election relates;
- (b) for corporation tax purposes, no later than 2 years after the end of the relevant chargeable period.

(3) For the purposes of this regulation—

- (a) “the year of assessment to which the election relates” means the basis period for that tax year in which the long funding lease election first takes effect under paragraph (1).and
- (b) “the relevant chargeable period” means the chargeable period in which the long funding lease election first takes effect under paragraph (1).

Here “chargeable period” has the meaning set out in section 6 of the CAA.

(4) A long funding lease election may be withdrawn by the electing lessor by notice in writing to the officer of Revenue and Customs to whom the long funding lease notice was given, at any time during the period set out in sub-paragraphs (2)(a) or (b).

Effects of election

5.—(1) If a long funding lease election has been made in accordance with these Regulations, the electing lessor shall be treated as if all the electing lessor’s eligible leases which were finalised on or after the date specified in regulation 4(1), had been long funding leases under Part 2 of the CAA since their inception.

(2) For the purposes of paragraph (1) “inception” has the meaning given in section 70YI of the CAA.

(3) A long funding lease election may not be withdrawn unless it is withdrawn by notice under the provisions of regulation 4(4).

A. Commissioner

A. N. Other

Two of the Lords Commissioners of Her Majesty’s Treasury

EXPLANATORY NOTE

(This note is not part of the Order)

These Regulations enable a lessor to elect to join the new long funding lease regime introduced by Schedules 8 and 9 of the Finance Act 2006 in respect of leases of plant or machinery that would not otherwise be covered by the legislation.

Regulation 1 provides for citation, commencement and interpretation.

Regulation 2 provides the mechanism for making an election.

Regulation 3 sets out the criteria for leases that must be met for an election to be made.

Regulation 4 sets out the commencement date and time limits within which an election can be made.

Regulation 5 sets out the effects an election will have.

A regulatory impact assessment in respect of the provisions of the Finance Act 2006 is available on the website of HM Revenue and Customs at www.hmrc.gov.uk/ria and may be obtained by writing to The Ministerial Correspondence Unit, 1st Floor, HM Revenue and Customs, Ferrers House, PO Box 38, Castle Meadow Road, Nottingham, NG2 1BB.

DRAFT GUIDANCE ON THE ELECTION TO TREAT LEASES AS LONG FUNDING LEASES

Introduction

1. An election for leases of plant or machinery to be treated as long funding leases may be made under SI 2006 No. XXXX.
2. This guidance explains who can make an election and the effect that it will have.

Who can make an election

3. The election may only be made by lessors of plant or machinery. A “lessor” is defined in s.70YI CAA and may be a company, individual or partnership.
4. “Lessor” does not include a group of companies. Therefore it is possible for some companies in a group to make an election while others do not. An election made by one group company does not apply to other companies in the group.

Scope of the election

5. The election only applies to eligible leases (paragraph 14 below).
6. Where a lessor makes an election it means that all of the lessor’s eligible leases will be long funding leases. All the provisions that apply to long funding leases apply to leases that are the subject of an election.
7. It follows that lessors may not make an election on a lease by lease basis. If a lessor makes an election it will cover all leases that are eligible to be included in the election.

The mechanics of making the election

8. An election must be made in writing to an officer of HM Revenue & Customs. While there is no specific form or form of words for the election, it must include:
 - the name and tax reference number of the lessor making the election, and
 - the date from which it is to be effective.
9. The election must be signed by a person who would be entitled to sign a return for the lessor business.
10. In the case of a lessor that is a company, this means that the election should be signed by the proper officer of the company (usually the Company Secretary) or any other person authorised by the company. The meaning of proper officer of the company is taken from s.108 TMA 1970.
11. In the case of a partnership, the election must be signed by the designated partner or his successor.
12. The normal rules for making an election apply. That is, whenever possible, an election should be made as part of the lessor’s return or amended return.

13. Note that the time limit for making an election (paragraph 35 below) may be reached before the time limit for making a return or amended return. For example, if a company's filing date is more than 12 months after the end of the period for which the return is made, the latest date for amending a return will be later than the date for making an election.

Eligible leases

14. To be eligible, a lease must meet all of the following conditions.

Condition A

15. The lease must be a plant or machinery lease as defined in s.70K CAA. Guidance on the definition of a plant or machinery lease is given at paragraph 2.9 of this Technical Note.

Condition B

16. The lease must not already be a long funding lease.

Condition C

17. The election may only be made in respect of leases finalised, as defined in paragraph 23 of Schedule 8, on or after 1 April 2006. Paragraph 23 defines a lease as finalised when all the following conditions are met –

- there is a contract in writing for the lease between the lessor and the lessee;
- either (a) the contract is unconditional, or (b) if it is conditional, the conditions have been met;
- no terms remain to be agreed.

Condition D

18. To meet condition D the lease must be of plant or machinery that meets one of three criteria.
19. The lease will meet this Condition if the plant or machinery is new (i.e. unused and not second-hand) at the commencement of the term of the lease (as defined in s.70YI CAA – see paragraph 2.43 of this Technical Note
20. The lease will also meet this Condition if the plant or machinery was last used for leasing under a long funding lease before the commencement of the term of the lease.
21. The lease will also meet this Condition where the lessor and lessee make a valid election under s.227 CAA.

Condition E

22. The election will not apply to leases of cars. A car is defined in s.81 CAA, as a mechanically propelled road vehicle other than one (a) of a construction primarily suited for the conveyance of goods or burden of any description or (b) of a type not commonly used as a private vehicle and unsuitable for use as such. This definition includes motorbikes.

23. It follows that leases of lorries and other commercial vehicles will fall within the scope of the election if all the other conditions are met.

Condition F

24. The election will not apply to individual assets costing more than £10m. That is, a lessor may make a long funding lease election but if he leased a ship costing £20m this particular lease would be outside the election. If the same lessor leased 1,000 pieces of equipment costing £20,000 each in one lease, then this lease would be included in the election.
25. Where a lease is for more than one asset and at least one of those assets cost more than £10m then the lease will be outside the scope of an election. For this test we take into account all assets, not just plant and machinery.

Condition G

26. The term of the lease must be at least 12 months.
27. The term of the lease has the meaning in s.70YF CAA, see paragraph 2.47 of this Technical Note

Condition H

28. The lease must not be a lease of background plant and machinery (s.70R CAA). Leases of background plant or machinery are described at paragraph 2.72 of this Technical Note. In broad terms background plant or machinery includes fixtures such as lifts and central heating that are leased with a building.
29. The value of the plant and machinery must not be small compared to the value of the land and buildings plus the value of the background plant and machinery. (Section 70U CAA; see paragraph 2.81 of this Technical Note).
30. This condition ensures that where particular leases of plant or machinery are specifically prevented from being long funding leases they are not treated as long funding leases as a result of an election.

Fixtures

31. Where a lessor leases a fixture, as long as the lessor does not have an interest in the land, and the leased fixture is plant or machinery, the lease will fall within the scope of an election.
32. Where the lessor has an interest in the land then lease will not fall within the scope of an election if the plant or machinery is background plant or machinery (s.70R CAA) or where the plant or machinery has a low value compared with the land (s.70U CAA) (paragraphs 2.72 and 2.81.)

Revoking an election

33. An election may only be revoked within the time limit for making the election.
34. If a lessor wishes to revoke an election he must do so in writing to an officer of HM Revenue and Customs. The revocation must be in an amended return.

Time limits for making an election

35. An election may take effect from any date from and including 1 April 2006. Once an election takes effect, all eligible leases will be treated as long funding leases.
36. An election must be made within set time limits:
- for corporation tax the election must be made no later than 2 years after the end of the chargeable period in which the election first takes effect;
 - for income tax, an election must be made on or before the first anniversary of the 31st January next following the year of assessment to which the election relates.
37. Example A lessor makes an election to be effective from 1 May 2007. This means that all eligible leases finalised after 1 May 2007 are treated as long funding leases. Non long funding leases finalised before 1 May 2007 will continue to be outside the scope of Schedule 8..

If the lessor making this election is a company with a 31 December accounting date, then the election must be made by 31 December 2009 – two years after the end of the chargeable period (31 December 2007) in which the election first took effect.

If the lessor is a partnership or sole trader then the election must be made by 31 January 2010. The election relates to 2007/08, the 31st January next is 2009 and the anniversary of this date is 31 January 2010.

Once made, the election may be revoked before 31 December 2009 (company) or 31 January 2010 (partnership, sole trader). After these dates the election may not be withdrawn.

The effect of making the election

Lessor

38. Once an election has been made by a lessor, all the lessor's eligible leases that are finalised after the date from which the election has effect become long funding leases. This includes all eligible leases that were finalised before the date of the election, even if, exceptionally, they have also terminated before that date.
39. The leases will be treated as long funding leases from inception, even if inception occurred before the date from which the election has effect. "Inception" is defined in s.70YI CAA (paragraph 2.41 of this Technical Note).
40. The taxation of long funding leases is described in detail in the body of this Technical Note.

Lessee

41. Lessees are not directly affected by a lessor making a long funding lease election. If an election is made, the leases become long funding leases in the hands of the lessor only.
42. In the vast majority of cases, in situations where a lessor makes an election the lessee will not view the lease as potentially a long funding lease. However, exceptionally, the fact that a lessor makes an election could allow a lessee to treat a lease as a long funding lease where he would not otherwise be able to do so. This is because where a lessor makes an election it is no longer entitled to

claim capital allowances and if, exceptionally, the lessee meets the conditions for having a long funding lease it will not be prevented from doing so by s.70Q CAA (see paragraph 4.44 of this Technical Note).

Following the accounts

Introduction

43. During the consultation process prior to the introduction of the regime for taxing long funding leases, lessors asked whether they could elect to be taxed on the basis of figures in the accounts. The election does not allow that, but –

- the rules for taxing long funding finance leases follow generally accepted accounting practice, and
- the rules for taxing long funding operating leases have significant similarities to accounting treatment and in some circumstances should produce the same result.

44. It follows that in some circumstances the figures that are used in the accounts will be practically the same as those that would be used if the strict statutory procedure were followed.

Finance leases

45. In outline, under the rules for taxing long funding finance leases –

- the amount to be brought in to the lessor's taxable income from a lease (i.e. as "rental earnings"), for a period of account, is the gross return on the investment calculated in accordance with generally accepted accounting practice.
- profits or losses that arise in connection with a lease, whether they are income or capital in nature, and which are recognised as profits or losses for accounting purposes are treated as taxable income or an allowable expense.
- termination payments paid to the lessee when the lease terminates (often referred to as a rebate of rentals) are not a deduction in computing profits, although this amount may be included in the computation of rental earnings.

46. For leases that are accounted for as finance leases the tax treatment for long funding leases reflects the accounting treatment. In other words, for finance leasing transactions only, the correct result for tax will inevitably rely on following the figures in the accounts.

Operating leases

47. In outline, under the rules for taxing long funding operating leases –

- the full rentals remain taxable but a deduction from profits is allowed to compensate for the lack of capital allowances. This deduction reflects the expected reduction in value of the asset (including additional capital expenditure), apportioned over the term of the lease on a straight line basis. In essence it is similar to depreciation (but see paragraph 52 below).

- any profits or losses arising to the lessor when the lease is terminated and the asset is sold are taxed or relieved when they arise. Profits or losses are calculated in accordance with the rules in s.502G ICTA or s.148F ITTOIA.
 - if an asset is used for a series of leases, the tax rules assume that the asset is revalued to market value at the end of each lease.
48. At the start of the lease the rules for long funding operating leases require the lessor to estimate the asset's residual value at the end of the lease. The difference between this figure and the asset's value at the start of the lease is spread, on a straight-line basis, over the life of the lease and deducted from each year's lease payments.
49. A lessor may base its tax computation on figures based on the accounts if the accounts' figures give a result that accords with the statute.
50. If the accounts' figures do not give a result that matches the statutory position then the accounts figures may be adjusted so that they do achieve the correct result.
51. In considering whether the figures in the accounts accord with the statutory result, there are three principle areas that need to be considered. These reflect the three issues mentioned in paragraph 47 above –
- Depreciation policy
 - Profits and losses on disposal
 - Valuation policy

Depreciation policy

52. Generally accepted accounting practice does not require businesses to use a straight-line depreciation policy, though that would normally be the case. However, there are variants on straight-line depreciation that do not mirror the rules for taxing long funding operating leases.
53. Example 1 An asset has an expected economic life of six years and is acquired by a lessor for £6000. It is leased under a four year operating lease at an annual rental of £1500. The lessor estimates that its value at the end of the lease will be £2000. The difference, £4000, will be an allowable deduction under s.502E ICTA (or s.148D ITTOIA), at a rate of £1000 per year.

The lessor depreciates the asset on a straight-line basis over the life of the asset with the result that the annual depreciation is £1,000. The depreciation is calculated on a time basis and the depreciation shown in the accounts varies according to when the asset is acquired.

That is, where the asset is acquired on the first day of the accounting period the depreciation is £1000; where the asset is acquired half way through the year, depreciation is £500. This is the same as the statutory deduction.

54. Example 2 As example 1, except that lessor's depreciation policy is to deduct a full year's depreciation in the accounts in the year of acquisition, whenever it is acquired. So even if the asset is acquired at the end of the period of account, the lessor accounts for a full year's depreciation.

55. Example 3 As example 1, but in the first year the lessor writes off one third of the value of the asset on the grounds that that reflects the actual loss in value of the asset over the first year of its life, and then moves on to straight line depreciation. This approach results in a deduction for depreciation of £2000, rather than the £1000 deduction.
56. Only the depreciation policy in Example 1 would allow a lessor to follow the figures in the accounts.
57. To be in line with s.502F ICTA the lessor would have to follow the same policy in respect of additional capital expenditure .

Profits and losses on termination of the lease

58. Profits or losses that accrue to the lessor when the lease is terminated and the asset is sold are taxed or relieved when they arise (s.502G ICTA and s.148F ITTOIA). The same applies to insurance proceeds, compensation and similar sums.
59. The lessor will need to demonstrate that its accounting policy delivers essentially the same results if it wishes to be taxed on figures that appear in the accounts.

Valuation policy

60. If the asset is not sold when the lease is terminated the rules in s.502G (and s.148F) ensure that a lessor is taxed on profits made over the term of the lease by using the concept of the termination value (s.70YH). In essence, where the plant or machinery is not sold, a notional profit or loss is brought into account as if the asset had been sold for market value.
61. Where a lessor leases an asset under a succession of leases and intends to base its return on figures in the accounts it will need to ensure that its accounting policy delivers essentially the same results as the statute.

Lessors with eligible and non-eligible leases

62. Lessors may have leases that are not eligible and so outside the scope of an election. Where this is the case, the figures in the accounts would need to be analysed to enable the necessary apportionments to be made.

General comments

63. "Following the accounts" does not mean that accounts may be followed for all purposes. It only means that where the accounts mirror the rules for taxing long funding leases then the taxation of those leases that are long funding leases a result of the election may be based on figures in the accounts.
64. This means, for example, that –
- depreciation of non-leased assets (and assets that may be leased but to which the election does not apply) must be dealt with in the normal way,
 - capital allowances remain available where the lease is neither a long funding lease nor an eligible lease for the purpose of this election,
 - entertaining expenditure needs to be added back,

- impairment provisions in respect of the value of the asset need to be added back.

ANNEX C – ALLOCATION OF EXPENDITURE TO CHARGEABLE PERIOD

Flow chart illustrating how the rules in s.220 CAA operate

