

REFORM OF CORPORATION TAX
PLANT AND MACHINERY LEASING
PARTIAL REGULATORY IMPACT ASSESSMENT

1. This RIA updates the partial RIA to be found in the background notes at http://www.inlandrevenue.gov.uk/consult_new/corp-tax-reform-bg-notes-080803.pdf which were published alongside the August 2003 consultation document *Corporation Tax Reform* (http://www.inlandrevenue.gov.uk/consult_new/corp-tax-reform.pdf). It takes into account the many helpful responses received to that consultation document.
2. In the August 2003 consultation document *Corporation Tax Reform* the Government considered the case for changing the tax treatment of leased plant and machinery, as part of the wider debate on the modernisation of the capital allowance regime.

PURPOSE AND INTENDED EFFECT OF MEASURE

THE OBJECTIVE

3. Current tax rules do not always lead to an appropriate interaction between investment and the incidence of taxation. Finance leasing and borrowing to purchase are commercially very similar and yet the tax treatments are very different. This difference in treatments, particularly the incidence of tax timing benefits that can be afforded by capital allowances, means that, in some cases, commercial decisions can be affected by the tax treatment of the transaction.
4. The objective of the proposal is that where leases function as financing transactions, and commercial decisions are affected by the tax treatment, they will be taxed in a similar way to loans.
5. Generally accepted accounting practice (GAAP) classifies leases as finance leases or operating leases. Finance leases are leases that transfer substantially all the risks and rewards of ownership to the lessee. Finance leases, by their nature, function as financing transactions. Some operating leases also function as financing transactions and these need to be identified if the policy objective is to be met.
6. The policy objective of taxing affected leases in a similar way to loans can be achieved by giving capital allowances to the economic owner of the asset, ie the lessee, and taxing lessors on the basis of the substance of the transaction, ie the making of a loan.

7. Leasing reform will allow the Government to remove current restrictions on overseas leasing and review the rules for allocating expenditure when an asset is acquired for finance leasing.
8. Not all leases that function as financing transactions carry a tax benefit that is likely to affect commercial decisions. In particular this is the case for shorter financing transactions – most leases of less than about 4 years, or in some cases up to about 6 years.
9. Currently these shorter leases comprise the great majority of leases by number. The policy objective will be met if the new regime includes an exemption for shorter leases. This will also minimise the impact on business.

THE BACKGROUND

10. As mentioned above, GAAP recognises two types of lease: finance leases and operating leases.
11. In practice, leases of plant and machinery exhibit a range of characteristics that place them on a spectrum from pure financing transactions to basic operating leases. Consequently some leases that are classified as operating leases for accounting purposes are essentially financing transactions. The reform proposes to introduce a special statutory definition that will identify all leases that function primarily as financing transactions. This definition will cover all finance leases and a small proportion of leases that, although correctly accounted for as operating leases, are essentially financing transactions. The leases covered by the definition are referred to here as 'funding leases'. There will also be rules that exclude shorter leases and so the new regime will only apply to 'long funding leases'.
12. A further proposed change is to review the rule for allocating expenditure to chargeable periods when an asset is acquired for finance leasing (in section 220 Capital Allowances Act 2001). Currently the amount of capital allowances available to a finance lessor in the period in which the leased asset is acquired is restricted to expenditure that is proportional to the part of the chargeable period for which the asset is held.
13. The effect of the reform will be to transfer, from the lessor to the lessee, any timing advantage given by capital allowances. This advantage does not usually exist where the lease is for about 4 years or less. Nor is there a significant benefit for full payout leases of up to about 6 years where the lease rentals are broadly similar throughout the term.
14. Although the reform will apply to a significant number of leases, typically with a high value, most leases will be excluded from the new regime by virtue of either:

- the definition of funding leases; or
- the rule to exempt shorter leases, potentially of up to about 6 years.

15. Where leases of plant and machinery are funding leases above the exemption limit, finance lessors will be taxed on the finance income recognised in their accounts, rather than on their gross rental receipts. In computing their taxable profits, finance lessees will be allowed to deduct the finance cost elements of rental payments as shown in their accounts. Similar rules will apply to operating leases. Capital allowances will be available to lessees rather than to lessors.

RISKS

16. It is economically undesirable for the tax system to bias the decision between lease finance and loan finance. The new regime aims to reduce the scope for tax considerations to influence the choice between different types of finance.

OPTIONS

17. One option would be to leave the current tax treatment of leases that essentially function as financing transactions unchanged. But this would not achieve the objective of reducing the influence of the tax system on different forms of finance.

18. The preferred option is to provide for the right to capital allowances to lie with the lessee where leases are long funding leases. Corresponding adjustments will be made to the taxable and deductible amounts of the rental payments – the interest elements in rental payments will be taxable on the lessor and deductible for the lessee, rather than the full rental payments. Broadly the effect will be that the lessor and lessee will be taxed as if the transaction had been a loan from the lessor to the lessee, with which the lessee had bought the asset.

19. Under the proposal, leases will be taxed in one of the following ways:

- the current regime will remain for most leases (i.e. non-funding leases, and shorter funding leases). The lessor will get capital allowances and will be taxed on the gross rentals, and the lessee will deduct gross rentals; or
- where leases are long funding leases the lessee will get capital allowances; and
 - where the lease is accounted for as a finance lease the lessor will be taxed on, and the lessee will deduct, the interest element of rentals shown in the accounts; but

- where the lease is accounted for as an operating lease the lessor will be taxed on, and the lessee will deduct, the gross rentals less the difference between the initial value and the estimated residual value of the asset, all on a straight-line basis.

BUSINESS SECTORS AFFECTED

19. The Inland Revenue has estimated that the total effect on investment in the UK economy will be to reduce investment by 0.07% - £80m pa of the total annual business investment of £110bn pa.
20. This modest reduction in investment arises mainly from the fact that some businesses, which have tax losses, will no longer be able to use long funding leases as a means of reducing their cost of capital. While businesses in any sector can be non-taxpaying because of losses, some sectors may be more prone to cycles with loss-making phases than others.
21. As the focus of the proposal is on longer leases, SMEs will not be among those affected, except in unusual circumstances. This is because the vast majority of leases to SMEs will be outside the new regime.
22. Longer non-funding leases will be not affected by the proposal but those longer leases that are affected could still be written, as the proposed new regime will tax them on the basis of their commercial substance.
23. Long funding lessees will benefit from capital allowances.
24. Comments are invited on any sectoral impact, positive or negative, that is not identified below.
25. Some sectors that will be affected more than others are identified below but in no case will the increase in funding cost be more than about 1 to 1.5% compared with leasing under the current regime.

SPECIFIC INDUSTRY SECTORS

PFI and Local Authorities

26. PFI projects often involve non-taxpaying end users and many contracts are constructed as composite trades where capital allowances are not in point. Where capital allowances are in point the impact of reform will be modest in many cases, both because transactions taxed as leases are relatively uncommon and because the leases that do exist will often fall outside the scope of the leasing proposal.

27. Comments are invited on the assumptions used and whether there are impacts that have not been identified.

Oil and gas

28. Special issues arise for oil and gas extraction activities. Comments are invited on specific impacts and considerations that need to be taken into account in development of the proposals for oil and gas extraction activities.

Shipping and tonnage tax

29. Tonnage tax companies do not get capital allowances, but they can still benefit from them indirectly when they lease ships by way of reduced rentals. Without further action, the proposals could impact on shipping companies that had elected for tonnage tax. The Government has therefore decided that the new regime will not effect existing arrangements for leasing into tonnage tax.

Rail

30. The Government understands that there should be little or no effect on leases of passenger rolling stock. If they continue to be written on the terms that are currently common, most, if not all, of them will be likely to fall outside the scope of the new regime. Comments are invited on the assumptions used and whether any specific category of rolling stock is more likely to be affected than others.

Air

31. Not all aircraft are financed by UK lessors and airlines already make extensive use of non-UK providers of finance which means that whilst there will be some impact on airlines' costs of obtaining aircraft, it is not yet clear how far this would extend within the industry. Comments are invited on the extent of any additional costs or savings and the basis on which they have been estimated.

Manufacturing

32. Some manufacturing firms with tax losses persisting over several years may experience a small increase in cost of capital if they are currently using leasing to finance plant and machinery with relatively long life (i.e. typically heavy plant). New-entrant inward investors to the UK might be examples of such firms, although recent UK leasing industry figures suggest that inward investors are not major users of UK leases. Comments are invited on the

validity of the assumptions and whether there are other unidentified factors that could influence the cost of capital under the new proposals.

COSTS FOR A TYPICAL BUSINESS

33. The changes are likely to affect a small proportion of leases. These are mainly leases of large assets for long periods. The effect of these changes is that the transactions will either be taxed as in the accounts or require relatively straightforward adjustments.
34. There is unlikely to be a significant increase in administration for any business. Businesses already maintain records of capital expenditure incurred. The proposals will affect tax computations but not the underlying records needed to prepare those calculations. For users of leases more widely, it should be very straightforward to determine the category of a lease for tax purposes.
35. Accordingly the typical business should not encounter any significant tax or compliance costs. The Government would welcome views on these aspects.

EQUITY AND FAIRNESS

36. The proposals will not affect a lease entered into before a set commencement date assuming that the asset was owned by the lessor at that time. Transitional rules will need to ensure that leases entered into after the commencement date will be allocated to the old or the new regime. These rules would, for example, take account of the date of the lease contract. Comments have been invited on the detail and practicality of any rules to be applied.
37. The Inland Revenue will publish detailed guidance on these changes at the time that they become law so that all businesses will be able to see the details of the changes. This guidance will be published on the Inland Revenue website.

COSTS AND BENEFITS

38. In assessing the costs and benefits, it is noted that the following will be unaffected:
- leases (of any type) entered into before the commencement date of any new regime (subject to the comments above relating to transitional rules);
 - most operating leases;
 - shorter funding leases excluded from the proposals.

39. Together these categories account for the vast majority of leases written by the asset finance and leasing industry.

40. There are currently no environmental or social cost impacts.

BENEFITS

41. The benefits from this measure will be that:

- it will remove an influence of the tax system on the choice between a loan and a lease that is essentially a financing transaction. It will allow the choice to be made on commercial grounds such as the level of security for the financing;
- the special rules for cross border leases will no longer be needed, which will facilitate the development of overseas leasing;
- the scope of the allocation rule may be able to be restricted, subject to any safeguards but nevertheless should be a significant simplification for business by reducing administrative and compliance costs.

COSTS

ADMINISTRATIVE COSTS

42. Due to the specialised nature of leasing there will be specific offices and staff that will require training. In addition, guidance manuals will require some rewriting to reflect both the new regime and its interaction with other areas of tax legislation.

EXCHEQUER COSTS

43. An Exchequer yield will arise from the proposed reform because some lessees, having tax losses, will be unable to use the capital allowances that the lessor can use under the existing regime. Against this, tax will no longer be received from lessors on the capital element of their rentals, but in the case of longer leases there will be a timing benefit from the change in the Exchequer's favour. While for any individual lease this is a timing effect only, given that there is a recurring annual volume of new leases the overall Exchequer effect is 2005/06 nil, 2006/07 £65m, 2007/08 £170m.

ASSUMPTIONS

44. The Government has assumed that businesses will structure leases to take account of the new rules and develop their businesses in a way that enables them to derive maximum benefit from the proposals.

SMALL FIRMS' IMPACT TEST

45. There has been consultation with the Small Business Service and representatives of small business. The general consensus was that, on the basis of the proposals then under discussion, the reform would have very little effect on small businesses.

46. The criteria of the Small Firms' Impact test were applied to this proposal. It is not envisaged that the changes will increase the administrative burden on small business. The records that will need to be kept will be no different to those already maintained by the majority of small and medium sized businesses.

OTHER IMPACTS

DEVOLUTION

47. Tax is a reserved matter. As the changes will apply equally to all businesses across the UK we consider that there would be no impact as regards devolution.

HUMAN RIGHTS/ E-POLICY/ ENVIROMENTAL IMPACTS/ RURAL PROOFING

48. Currently there are no impacts on the above areas as a result of this proposal.

COMPETITION ASSESSMENT

49. A competition filter test was applied to these changes.

50. The market most directly affected by the changes will be the leasing industry. The distribution of market shares in this industry indicates that it is at least moderately competitive. Those firms with a high level of participation in the long-term 'big-ticket' segment of the market may be disproportionately affected. This may cause some firms to reduce in size. However, it appears unlikely that the total number of financial and other groups offering leasing

services will decline to the extent that the market would become significantly less competitive. The risk that the changes may have a significant detrimental effect on competition is therefore seen as low.

51. Other markets potentially affected by this change might be among those, which are users of leasing finance. As mentioned in paragraphs 19-32 firms in some industries may experience a modest increase in cost of capital for investment currently funded by means of leasing. In theory this would be more likely to affect new entrants in such industries than firms with established profits. However, the evidence does not suggest that the current tax treatment of leasing is commonly a decisive factor in encouraging new firms to enter industries. It is therefore unlikely that the change will significantly affect competition in any markets that use leasing.
52. In view of these conclusions, a detailed competition assessment is not included here.

SECURING COMPLIANCE

53. No changes to the existing compliance provisions are required. The normal risk assessment process by which a business's returns and accounts are taken up for enquiry will continue to allow the Inland Revenue to check that the self-assessments of businesses are correct.
54. The Inland Revenue will publish detailed guidance externally and to its staff on these changes as appropriate. The guidance will be published on the Inland Revenue website.

CONSULTATION

Public consultation

55. Following the publication of the August 2003 consultation document, a series of consultation meetings was held. More than 50 representatives of business attended these meetings. Additional meetings were held with particular business sectors and industry representatives with a special interest in leasing and in the effect of reform on lessors and lessees.
56. There were 148 written responses to the August 2003 consultation document. Many of those that referred to the proposed leasing reforms have engaged in further informal discussion and facilitated an understanding of the practical and technical aspects of the policy development.
57. The Government has welcomed the comments that it has received from business during the periods of consultation. It has used these comments to develop the changes proposed in the technical note.

58. The Inland Revenue is publishing draft core legislation for the new regime in the technical note. It will welcome comments on the draft legislation.

Consultation within Government

59. The Department of Trade and Industry, Cabinet Office Regulatory Impact Unit, Small Business Service and HM Treasury have been involved in ongoing CT Reform consultation. There has also been wide consultation within the Inland Revenue including policy, operational and technical teams.

MONITORING AND EVALUATION

60. These proposals form part of a package of measures to reform corporation tax. They will contribute to the Government's balancing of competitiveness and fairness in taxation. Isolating the direct and behavioural impact of this proposal separately from that of other measures is likely to be difficult.

61. As part of the consultation process the Inland Revenue will review the compliance cost predictions contained in this RIA and make the necessary changes when publishing the final RIA.

SUMMARY AND RECOMMENDATION

62. In summary, changes to the leasing legislation will reduce the influence of the tax system on the choice of methods of finance. Such changes will also allow the Government to remove current restrictions on overseas leasing and review the rules for allocating expenditure when an asset is acquired for finance leasing.

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