HM Revenue & Customs

Leasing avoidance by film partnerships

Draft Legislation and Explanatory Note
24 November 2008

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Introduction

On 13 November 2008, the Government announced it was taking action to counter avoidance by film leasing partnerships. This document provides draft legislation and Explanatory Notes.

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Chapter 1 – The effect of the legislation

1. On 13 November 2008 the Government announced that it is taking action to prevent partnerships that have in the past invested in films attempting to avoid tax by means of converting existing leases into long funding leases.

2. A Technical Note, which is available on HMRC's web site, was published on the same day which explains why the legislation is needed and what it will do.

3. This document provides a draft of the legislation that will be included in the Finance Bill 2009, together with draft Explanatory Notes.

4. For convenience, this Technical Note repeats much of what was said in the Technical Note published on 13 November.

The legislation

Outline

5. In broad terms, the legislation will ensure that rentals received under long funding leases of films will be taxed in full. However, it will only apply to rents that are receivable on or after 13 November 2008 and which relate to periods of time beginning on or after that date.

6. In practice, this legislation is expected to apply mostly to partners in film leasing partnerships but it will also apply to other persons entering into long funding leases of films.

Long funding lease of a film entered into on or after 13 November 2008

7. Where a long funding lease of a film is entered into[1] on or after 13 November 2008, the provisions in Income and Corporation Taxes Act 1988 ('ICTA') and Income Tax (Trading and Other Income) Act 2005 ('ITTOIA') that limit the lessor's taxable income will not apply and, instead, the lessor will be taxed on its income in the same way it would be taxed if the lease was not a long funding lease.

8. This is achieved by new section 502GD ICTA in the case of corporation tax and new section 148FD ITTOIA in the case of income tax.

9. The new rules, which are in paragraphs 1 to 3 of the draft legislation, apply to both long funding operating and long funding finance leases.

Long funding finance lease of a film entered into before 13 November 2008

10. Transitional rules will apply where a long funding finance lease of a film was entered into before 13 November 2008. These rules are contained in paragraphs 4 to 9 of the draft legislation.

11. In this situation, the taxation of rents due to be paid before 13 November will not be affected by the new rules (paragraphs 5(2)(b) and 6(2) of the draft legislation).

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[1] For the purposes of this legislation a lease is 'entered into' on the date of inception, as defined in section 70YI(1) Capital Allowances Act 2001.

12. However, where rents are paid after that date and relate to periods of time beginning on or after that date the lessor will be taxed, not only on the finance charge element of the rents (as it already is under the existing long funding lease rules), but also on so much of the capital element of the rentals as relates to periods of time after 13 November.

13. Where the capital element falls to be taxed it will be allocated to the period of time to which it relates. This is illustrated in the examples below.

14. In addition –

- sections 502C ICTA and 148B ITTOIA will not apply for determining profits or losses arising on or after 13 November (see paragraph 7 of the draft legislation), and

- if section 502D ICTA or 148C ITTOIA applies to a termination on or after 13 November, a deduction will be allowed in calculating the profits of the lessor but the amount that is allowed as a deduction will be limited to the amounts brought into account by these new rules (see paragraph 8 of the draft legislation).

15. The legislation will not be limited to applying where the lessor has claimed relief for the cost of the film under section 42 of Finance (No.2) Act 1992, section 48 Finance (No.2) Act 1997 or sections 138 to 140 ITTOIA 2005 as it is possible the long funding lease rules could be abused where relief for the cost of the film is obtained in other ways.

16. As the leases involved are long funding leases, then, as is provided by the existing legislation, lessors will not be entitled to claim capital allowances.

Examples

<u>Example 1</u>

17. Assume a partnership has an accounting year ending on 31 December, and it received rent of:

- £15,000 on 1 November 2008 for the year to 31 October 2009 of which £4,000 represents finance charges and £11,000 represents the capital element;

- £15,000 on 1 November 2009 for the year to 31 October 2010 of which £3,000 represents finance charges and £12,000 represents the capital element.

18. In this example the new rules will apply as follows.

19. The finance charges arising in the years to 31 December 2008 and 2009 will be taken into account in calculating taxable income, as now. No special legislation is needed to achieve this.

20. Paragraph 6 of the draft legislation will apply to the year to 31 December 2008 but the £11,000 capital element of the rent paid on 1 November 2008 will not be taken into account in calculating income because of sub-paragraph (2)(b). Therefore there will be no change to the partnership's calculation of taxable income for the year to 31 December 2008.

21. Paragraph 6 will also apply to the year to 31 December 2009. In this case the £12,000 capital element of the rent paid on 1 November 2009 will be taxed: £2,000 will represent income of the year to 31 December 2009 and will increase the partnership's taxable income for that year; £10,000 will be included in calculation of the partnership's income for the year to 31 December 2010.

<u>Example 2</u>

22. Again assume a partnership has an accounting year ending on 31 December, and it received rent of:

    - £15,000 on 31 December 2008, representing rent in arrears for the year to 31 December 2008, of which £4,000 represents finance charges and £11,000 represents the capital element.

23. In this example the new rules will apply for the year to 31 December 2008 as follows.

24. The finance charges will be taken into account in calculating income, as now.

25. Paragraph 6 of the draft legislation will apply and, as the rent is paid after 13 November and relates, in part, to a period of time after that date a proportion of the £11,000 capital element will be taken into account in calculating taxable income. That proportion represents the 49 days from 13 November to 31 December and is 49/365 x £11,000 = £1,477.

Chapter 2 – Draft Legislation

This section contains the current draft of the legislation.

SCHEDULE 1

LONG FUNDING LEASES OF FILMS

1 After section 502GC of ICTA insert—

"502GD Cases where ss 502B to 502G do not apply: films

(1) If a company is or has been a lessor under a long funding lease of a film, sections 502B to 502G do not apply in respect of the lease.

(2) "Film" has the same meaning as in Chapter 3 of Part 3 of the Finance Act 2006 (see section 31 of that Act)."

2 After section 148FC of ITTOIA 2005 insert—

"148FD Cases where ss 148A to 148F do not apply: films

(1) If a person is or has been a lessor under a long funding lease of a film, sections 148A to 148F do not apply in respect of the lease.

(2) "Film" has the same meaning as in Chapter 3 of Part 3 of FA 2006 (see section 31 of that Act)."

3 The amendments made by paragraphs 1 and 2 have effect where the inception of the long funding lease is on or after 13 November 2008 ("the relevant date").

4 Paragraphs 5 to 8 apply in respect of a long funding finance lease of a film—
(a) whose inception is before the relevant date, and
(b) which has not terminated before that date.

5 (1) Section 502B of ICTA or section 148A of ITTOIA 2005 (rental earnings) does not apply to a period of account within sub-paragraph (2).

(2) A period of account is within this sub-paragraph if—
(a) it begins on or after the relevant date, and
(b) no rentals due (wholly or partly) in respect of any part of the period of account were due under the lease before the relevant date.

6 (1) For the purpose of calculating the profits of the lessor under the lease for a period of account—
(a) that ends on or after the relevant date, and
(b) that is not within paragraph 5(2),
treat the lessor as receiving for that period of account income attributable to the lease of an amount equal to the relevant amount (in addition to any amount brought into account under section 502B(2) of ICTA or section 148A(2) of ITTOIA 2005).

(2) The "relevant amount" is an amount equal to so much of the rentals as—
(a) become due on or after the relevant date, and
(b) are due wholly or partly in respect of the period of account,
as would not reasonably be regarded as reflected in the rental earnings for that period of account.

(3) If any rental is paid for a period ("the rental period") which—
(a) begins before the relevant date, or
(b) is not wholly within the period of account,

for the purposes of sub-paragraph (2) treat the amount of that rental as equal to the amount apportioned (on a time basis) in respect of so much of the rental period as falls on or after the relevant date and within the period of account.

7 Section 502C of ICTA or section 148B of ITTOIA 2005 (exceptional items) does not apply in relation to any profit or loss arising on or after the relevant date.

8 (1) If section 502D of ICTA or section 148C of ITTOIA 2005 (lessor making termination payment) applies in respect of the termination of the lease on or after the relevant date, a deduction is allowed (in calculating the profits of the lessor) in respect of any sum calculated by reference to the termination value paid to the lessee.

(2) The amount of the deduction is (if it would otherwise exceed that amount) limited to the total amount brought into account in respect of the lease by virtue of paragraph 5 or 6.

9 For the purpose of paragraphs 3 to 8—

(a) "film" has the same meaning as in Chapter 3 of Part 3 of FA 2006 (see section 31 of that Act),

(b) "rental earnings" has the same meaning as in section 502B of ICTA or section 148A of ITTOIA 2005, and

(c) Chapter 6A of Part 2 of CAA 2001 (interpretation of provisions about long funding leases) applies.

Chapter 3: Draft Explanatory Note

This section contains the draft Explanatory Note based on the current draft of the legislation.

SUMMARY

1. This Schedule introduces legislation to prevent the avoidance of tax involving long funding leases of films.

DETAILS OF THE SCHEDULE

2. <u>Paragraph 1</u> introduces new section 502GD into the Income and Corporation Taxes Act 1988 ('ICTA').

3. <u>New section 502GD</u> provides that where a company is (or has been) the lessor of a film the taxation of its rental income from those leases is not affected by the rules that apply to long funding leases.

   a. <u>Subsection (1)</u> provides that the sections in ICTA that affect the taxation of a lessor's income under a long funding lease do not apply.

   b. <u>Subsection (2)</u> provides that 'film' has the meaning given by section 31 Finance Act 2006.

4. <u>Paragraph 2</u> introduces new section 148FD into the Income Tax (Trading and Other Income) Act 2005 ('ITTOIA'). It is the income tax equivalent of section 502GD ICTA.

5. <u>New section 148FD</u> provides that where a person is (or has been) the lessor of a film the taxation of its rental income from those leases is not affected by the rules that apply to long funding leases.

   a. <u>Subsection (1)</u> provides that the sections in ITTOIA that affect the taxation of a lessor's income under a long funding lease do not apply.

   b. <u>Subsection (2)</u> provides that 'film' has the meaning given by section 31 Finance Act 2006.

6. <u>Paragraph 3</u> gives the commencement rules for paragraphs 1 and 2. These paragraphs only apply where the inception of the long funding lease is on or after 13 November 2008. The meaning of 'inception' is given by section 70YI(1) Capital Allowances Act 2001 (applied by paragraph 9 of this Schedule).

7. <u>Paragraph 4</u> introduces paragraphs 5 to 8 of the Schedule. These paragraphs provide transitional rules that apply to long funding finance leases of films, the inception of which was before 13 November 2008 and which have not ended by that date.

8. Paragraph 5 applies to certain chargeable periods and disapplies the rules that restrict the amount of a lessor's income that may be taxed under a long funding finance lease.

9. Sub-paragraph (1) disapplies the rules in section 502B ICTA (in the case of corporation tax) or section 148A ITTOIA (in the case of income tax). This transitional rule applies to periods of account that meet the conditions in sub-paragraph (2).

10. Sub-paragraph (2) provides that this paragraph only applies to periods of account that begin on or after 13 November 2008 and to which no part of any rental due to be paid before that date refers.

11. Paragraph 6 provides further transitional rules that apply to lessors where paragraph 5 does not apply to the chargeable period.

12. Sub-paragraph (1) provides that the paragraph applies to chargeable periods that end on or after 13 November 2008 and to which paragraph 5(2) does not apply. Where this sub-paragraph applies the lessor is treated as receiving an amount of income in addition to that which is brought into account as representing the finance charge element of the lease rentals. This amount is known as the relevant amount.

13. Sub-paragraph (2) defines the "relevant amount" as the proportion of the 'capital' element of the rentals (referred to here as that part of the rentals as would not reasonably be regarded as reflected in the rental earning for that period of account) which are payable on or after 13 November 2008 and which relate to the period of account.

14. Sub-paragraph (3) applies for the purpose of sub-paragraph (2) where a rental is paid for a period of time that begins before 13 November 2008 and does not fall wholly within the period of account. Where this sub-paragraph applies the rental is apportioned to the period of account on a time basis.

15. Paragraph 7 provides that (where the conditions in paragraph 4 are met) section 502C ICTA or section 148B ITTOIA do not apply. These sections apply for corporation tax and income tax respectively and make provision for the taxation of exceptional items arising in connection with the lease.

16. Paragraph 8 applies where the conditions in paragraph 4 are met and ensures that a lessor is entitled to an appropriate deduction if it makes a refund of rentals at the end of the lease term.

17. Sub-paragraph (1) provides that if a deduction in respect of a refund of rentals (described as a sum calculated by reference to the termination value) is otherwise prohibited by section 502D ICTA or section 148C ITTOIA then a deduction in respect of that refund is allowed.

18. Sub-paragraph (2) provides that the amount of the deduction is limited to the amount brought into account in computing income under paragraph 5 or 6 of this Schedule.

19. Paragraph 9 provides definitions for the purposes of paragraphs 3 to 8.

BACKGROUND NOTE

20. This Schedule counters avoidance involving the leasing of films under long funding leases of plant or machinery.

21. Partnerships typically acquired or produced films and leased them to other companies to be exploited over a period of up to 15 years (referred to here as "sale and leaseback arrangements"). The partnerships were able to claim relief for the cost of those films under section 42 of Finance (No.2) Act 1992, section 48 Finance (No.2) Act 1997 or sections 138 to 140 Income Tax (Trading and Other Income) Act 2005 ('ITTOIA').

22. The rents under the lease are taxable and, in effect, these sale and leaseback arrangements allow the partners to defer their tax liability for up to 15 years.

23. The avoidance involves the partnerships ending the existing leases and replacing them with new leases that are intended to qualify as long funding finance leases of plant or machinery.

24. If these new leases are long funding finance leases the majority of the rents receivable will not be taxed as section 148A ITTOIA (for income tax) or section 502B Income and Corporation Taxes Act 1988 (for corporation tax) will apply. In effect, the partnerships will have replaced a taxable income stream with one that is largely untaxed.

25. Although the known avoidance involves partnerships, it is possible that others could seek to avoid tax using the same methods. Therefore the new rules are not limited to partnerships.