

Corporation Tax: Bill 6
Long funding leases of plant or machinery
November 2008: Committee paper CC/SC (08) 54

Part 1: Leasing plant or machinery

Overview

1. The paper with which this commentary is published presents a Chapter rewriting Chapter 5A of Part 12 of ICTA (special rules for long funding leases of plant or machinery) which is intended to form a Part of Bill 6 together with Chapters rewriting Schedule 10 to FA 2006 (Sales etc of lessor companies etc).

2. The expected structure of the Part is as follows:

- Chapter 1 will provide an introduction to the Part.
- Chapter 2 will rewrite Chapter 5A of Part 12 of ICTA.
- Chapters 3 to 5 will rewrite Schedule 10 to FA 2006.

3. Chapters 1 and 3 to 5 were published on 14 October 2008 under committee paper CC/SC (08) 41: Leasing plant or machinery: the sales of lessors Chapters.

4. The commentary uses a number of abbreviations. They are listed below.

CAA	the Capital Allowances Act 2001
FA 2006	the Finance Act 2006 (and similarly for other Finance Acts)
ICTA	the Income and Corporation Taxes Act 1988
ITTOIA	the Income Tax (Trading and Other Income) Act 2005.

Chapter 2: Long funding leases of plant or machinery

Overview

5. This Chapter rewrites Chapter 5A (special rules for long funding leases of plant or machinery) inserted into Part 12 of ICTA by Part 2 of Schedule 8 to FA 2006.

6. Schedule 8 to FA 2006 reformed the way in which certain finance leases of plant or machinery, and operating leases of plant or machinery akin to such finance leases, are taxed. In broad terms it does so by:

- moving entitlement to capital allowances in relation to the plant or machinery under such a lease – a “long funding lease” - from lessor to lessee and
- taxing the lessor and lessee in relation to the financing of the plant or machinery through such a lease in much the same way as lender and borrower would be taxed in relation to financing the plant or machinery through a loan.

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7. Part 1 of Schedule 8 to FA 2006 substantially amended Part 2 of CAA (Plant and machinery allowances) by introducing new sections 70A to 70E into Chapter 6 and new Chapter 6A (sections 70F to 70YJ). Parts 2 and 3 of that Schedule respectively introduced Chapter 5A into Part 12 of ICTA for corporation tax purposes and Chapter 10A into Part 2 of ITTOIA containing corresponding provisions for income tax purposes.

8. FA 2008 introduced new sections 502GA to 502GC of ICTA (and new sections 148FA to 148FC of ITTOIA) to disapply the revised basis of taxation of lessors under sections 502B to 502G of ICTA (and sections 148A to 148F of ITTOIA) in certain circumstances. In those circumstances, the basis of taxation remains that applicable to lessors before the reforms made by FA 2006.

9. Section 502H of ICTA (insurance company as lessor) is not rewritten as it has been repealed by FA 2007 and FA 2008.

10. The vast majority of the persons who are lessors under long funding leases are companies within the charge to corporation tax. In rewriting Chapter 5A of Part 12 of ICTA, the presentation of some of the calculations required in relation to lessors has been substantially restructured and the provisions in a single section divided into a number of clauses. We consider that the revised structure improves the accessibility of the legislation and will be helpful to lessor companies and their advisers. On the basis that only a minority of lessors of plant or machinery under long funding leases are likely to be within the charge to income tax, we are doubtful that it is imperative that the corresponding income tax provisions of ITTOIA are rewritten.

11. In the commentary on the relevant clauses, we invite comments on the restructured provisions and on the necessity or desirability of conforming the corresponding provisions of ITTOIA.

Clause 1: Introduction

12. This clause sets out the structure of the Chapter and contains a signpost to clause 22 for the meaning of terms used in the Chapter. It is new.

13. The Chapter is arranged so that it deals first with the calculation of the taxable profits of the lessor and then with the calculation of the taxable profits of the lessee. In each case it deals with the lessor or lessee first as party to a long funding finance lease and then as party to a long funding operating lease.

14. The terms “long funding lease” and “long funding finance lease” take their meaning from Chapter 6A of Part 2 of CAA and “long funding operating lease” is defined by reference to those terms. See clause 22(2).

15. It is an integral part of the definition of “long funding lease” in CAA that the subject matter of the lease is plant or machinery (see sections 70G, 70J and 70K of CAA).

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Clause 2: Lessor under long funding finance lease: rental earnings

16. This clause determines the taxable income of the lessor from a long funding finance lease. It is based on section 502B of ICTA.

17. The taxable income is the amount of rental earnings. The calculation of rental earnings follows generally accepted accounting practice. The rental earnings is the amount that in accordance with that practice is to be treated as gross return on investment or, in a case where in accordance with that practice the lease is to be treated as a loan, as interest.

18. Section 502B(3) of ICTA includes in relation to the lease the words “where it meets the finance lease test”. Those words are otiose and have been omitted from *subsection (3)*.

19. Section 502B(4) of ICTA refers to the lease being “treated as a loan in the accounts in question”. There is no other reference to “accounts” in section 502B and those words have been changed in *subsection (4)* to read “treated as a loan for the period of account” linking back to the “period of account” mentioned in *subsection (1)*.

Clause 3: Lessor under long funding finance lease: exceptional items

20. This clause treats as taxable income or a revenue expense certain profits or losses in connection with a long funding finance lease which would not apart from this clause be brought into account for corporation tax purposes. It is based on section 502C of ICTA.

21. The profits and losses to be brought into account are those (whether of an income or capital nature) which in accordance with generally accepted accounting practice fall to be recognised for accounting purposes.

Clause 4: Lessor under long funding finance lease making termination payment

22. This clause prohibits a deduction by a lessor for a payment made in respect of the termination of a long funding finance lease if the amount of the payment is calculated by reference to “termination value”. It is based on section 502D of ICTA.

23. On termination of a finance lease of an asset, the lessor often makes a payment to the lessee, commonly referred to as a rebate of rentals. This payment principally represents partial reimbursement of payments made by the lessee in respect of the capital value of the asset, unencumbered possession of which has reverted to the lessor as a result of the termination. This clause prevents such a payment from being deducted by the lessor for corporation tax purposes. But the clause does not prevent the deduction of a payment to the extent it is included in computing rental earnings (see *subsection (3)*).

24. *Subsection (4)* is new and provides a signpost to the definition of “termination value”.

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Clause 5: Lessor under long funding operating lease: periodic deduction

25. This clause compensates a lessor under a long funding operating lease for the fact that capital allowances in relation to the leased plant or machinery are not available to it. It is based on section 502E(1) to (3) and (6) to (9) of ICTA.

26. In the case of an operating lease, the gross rentals are to be brought into account for corporation tax purposes. This achieved the correct result prior to FA 2006, as the lessor was entitled to capital allowances which over the term of the lease balanced the amount brought into charge that represented payment of the capital value of the leased plant or machinery.

27. This clause replaces the role of capital allowances. It allows deductions in calculating the profits of the lessor for corporation tax purposes, which over the term of the lease equate in total to the expected reduction in value of the plant or machinery over the term.

28. The words “had that value been estimated at that time” have been added in *subsection (4)(b)* to explain the reasoning behind the use of the words “would have been expected” in section 502E(6)(b) of ICTA.

29. This clause, together with clauses 6 and 7, presents the calculation required by section 502E of ICTA in a substantially different way. We have restructured the provision with the intention of improving the accessibility of the legislation for lessor companies and their advisers, in particular by splitting out the different basis of calculation required where the lessor incurred expenditure on the provision of the plant or machinery otherwise than for a qualifying purpose.

Q1. We welcome comments on the revised presentation of the calculation adopted in clauses 5 to 7 and seek views on whether it is necessary or desirable to amend the structure of section 148D of ITTOIA to conform with any restructuring of the provisions of section 502E of ICTA in this Bill.

Clause 6: Meaning of “starting value”: general

30. This clause determines the “starting value” of the plant or machinery for the purposes of the calculation required by clause 5 except in the circumstances where clause 7 applies. It is based on section 502E(4) and (5) of ICTA.

Clause 7: “Starting value” where plant or machinery originally unqualifying

31. This clause determines the “starting value” of the plant or machinery for the purposes of the calculation required by clause 5 in a case where, before the long funding operating lease commenced, the lessor incurred expenditure on the plant or machinery otherwise than for the purposes of a qualifying activity within the meaning of Part 2 of CAA. It is based on section 502E(4) and (5) of ICTA.

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Clause 8: Long funding operating lease: lessor's additional expenditure

32. This clause provides for an additional deduction by a lessor under a long funding operating lease if the lessor incurs additional expenditure in relation to the leased plant or machinery. It is based on section 502F(1) to (4) and (7) to (11) of ICTA.

33. This clause, together with clauses 9 and 10, presents the calculation required by section 502F of ICTA in a substantially different way. We have restructured the provision with the intention of improving the accessibility of the legislation for lessor companies and their advisers, in particular by splitting out the different basis of calculation required where the lessor has previously incurred additional expenditure.

Q2. We welcome comments on the revised presentation of the calculation adopted in clauses 8 to 10 and seek views on whether it is necessary or desirable to amend the structure of section 148E of ITTOIA to conform with any restructuring of the provisions of section 502F of ICTA in this Bill.

Clause 9: Determination of remaining residual value resulting from lessor's first additional expenditure

34. This clause determines the amount of the remaining residual value of the plant or machinery for the purposes of clause 8 as a result of the first occasion on which the lessor incurs additional expenditure. It is based on section 502F(5) and (6) of ICTA.

35. The words “(or, if section 7 applies, would have been expected to be that value had that value been estimated at that time)” in *subsection (2)(b)* reflect the wording of clause 5(4)(b). See the commentary on clause 5.

Clause 10: Determination of remaining residual value resulting from lessor's further additional expenditure

36. This clause determines the amount of the remaining residual value of the plant or machinery for the purposes of clause 8 as a result of the second and subsequent occasions on which the lessor incurs additional expenditure. It is based on section 502F(5) and (6) of ICTA.

37. The words “(or, if section 7 applies, would have been expected to be that value had that value been estimated at that time)” in *subsection (3)(a)* reflect the wording of clause 5(4)(b). See the commentary on clause 5.

Clause 11: Lessor under long funding operating lease: termination of lease

38. This clause provides for the lessor to be treated as receiving income, or, depending on the circumstances, incurring a revenue expense for corporation tax purposes on the termination of a long funding operating lease. It is based on section 502G of ICTA.

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39. Whether or not income is treated as being received or a revenue expense as being incurred is determined by reference to “the termination amount” and the amounts mentioned in *subsection (3)(a) to (c)*, but the amounts mentioned in *subsection (3)(a)* (amounts paid to the lessee by reference to the termination value) may not themselves be deducted (see *subsection (5)*).

40. We have substantially restructured the presentation of the calculation required by section 502G of ICTA with the intention of improving the accessibility of the legislation for lessor companies and their advisers.

Q3. We welcome comments on the revised presentation of the calculation adopted in clause 11 and seek views on whether it is necessary or desirable to amend the structure of section 148F of ITTOIA to conform with any restructuring of the provisions of section 502G of ICTA in this Bill.

Clause 12: Plant or machinery held as trading stock

41. This clause disapplies clauses 2 to 11 if, apart from those clauses, any part of the lessor’s expenditure on the acquisition of the plant or machinery is allowable as a deduction for corporation tax purposes as a result of its forming part of the lessor’s trading stock. It is based on section 502GA(1) to (3) of ICTA.

Clause 13: Adjustments where sections 2 to 11 subsequently disapplied by section 12

42. This clause applies if clauses 2 to 11 previously applied, but the condition in clause 12(2) is subsequently met. It is based on section 502GA(4) and (5) of ICTA.

43. The clause provides for just and reasonable assessments and adjustments to assessments to be made in relation both to the amounts taken into account in accordance with clauses 2 to 11 and to those to be taken into account in accordance with clause 12.

Clause 14: Lessor also lessee under non-long funding lease

44. This clause disapplies clauses 2 to 11 in the case of a company which as lessor grants a long funding lease (lease B) of plant or machinery in which its interest is that of a lessee under a lease (lease A) which is not a long funding lease. It is based on section 502GB of ICTA.

45. Section 70H of CAA provides that a lease otherwise capable of being a long funding lease is not a long funding lease as regards the lessee unless the lessee has made a tax return treating the lessee as taxable in relation to the lease in accordance with Chapter 5A of Part 12 of ICTA. *Subsection (3)(a)* ensures that, if a tax return is made validly treating lease A as being a long funding lease after lease B has been entered into, this clause is treated as never having applied to lease B. *Subsection (3)(b)* ensures that this clause does apply to lease B, if a tax return which

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treated lease A as being a long funding lease is subsequently amended so as not to treat it as such a lease.

Clause 15: Other avoidance

46. This clause disapplies clauses 2 to 11 where three conditions are met. It is based on section 502GC(1) to (3) and (5) of ICTA.

47. The three conditions counter arrangements involving a long funding lease which are intended to create tax profits which are substantially less than, or tax losses which are substantially greater than, the profits or losses arising from the arrangements as shown in the lessor company's accounts. The clause may also apply where there is a tax loss and an accounting profit.

Clause 16: Provision supplementing section 15

48. This clause provides definitions and interpretation for the purposes of clause 15. It is based on section 502GC(2), (4) and (6) to (8) of ICTA.

Clause 17: Adjustments where sections 2 to 11 subsequently disapplied by section 15

49. This clause applies if clauses 2 to 11 have previously applied, but the conditions in clause 15 are subsequently met. It is based on section 502GC(9) and (10) of ICTA.

50. The clause provides for just and reasonable assessments and adjustments to assessments to be made in relation both to the amounts taken into account in accordance with clauses 2 to 11 and to those to be taken into account in accordance with clause 15.

Clause 18: Lessee under long funding finance lease: limit on deductions

51. This clause, the first of those relating to lessees, limits the amount which a lessee of plant or machinery under a long funding finance lease may deduct in calculating its profits for corporation tax purposes. It is based on section 502I of ICTA.

52. The amount which may deducted is limited to the amounts which in accordance with generally accepted accounting practice fall to be shown in the lessee's accounts as finance charges in respect of the lease (see *subsections (2) and (3)*).

53. In certain circumstances in accordance with generally accepted accounting practice a long funding finance lease is treated as a loan for accounting purposes. This clause applies as if such a lease were treated as a finance lease (see *subsection (4)*).

Clause 19: Lessee under long funding finance lease: termination

54. This clause avoids double taxation by excluding from the lessee's calculation of its profits for corporation tax purposes any sum received by the lessee in relation to

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a long funding finance lease which is calculated by reference to “termination value”. It is based on section 502J of ICTA.

55. Such sums must, however, be brought into account as part of the disposal value for the purpose of capital allowances (see *subsection (3)* and section 70E of CAA).

56. *Subsection (4)* is new and provides a signpost to the definition of “termination value”.

Clause 20: Lessee under long funding operating lease

57. This clause reduces the deductions which a lessee under a long funding operating lease of plant or machinery may make in calculating its profits for corporation tax purposes. It is based on section 502K(1) to (3) and (6) to (9) of ICTA.

58. The amount of the deduction is reduced by reference to the expected reduction in value of the plant or machinery over the term of the lease. As the lessee is entitled to capital allowances, it effectively obtains relief through the allowances for the amount of the lease payments which it cannot deduct in calculating its profits.

59. The words “had that value been estimated at the commencement of the term” have been added in *subsection (6)(b)* to explain the reasoning behind the use of the words “would have been expected” in section 502K(6)(b) of ICTA.

Clause 21: Meaning of “starting value” in section 20

60. This clause determines the “starting value” of the plant or machinery for the purposes of the calculation required by clause 20. It is based on section 502K(4) and (5) of ICTA.

Clause 22: Interpretation of Chapter

61. This clause defines or provides signposts to the provisions defining terms used in the Chapter. It is based on section 502L of ICTA.

62. To assist the user, this clause expands on section 502L(4) of ICTA, rewritten in *subsection (1)*, by including numerous signposts to specific sections of Part 6A of CAA in *subsections (2)* and *(3)*.