

LEASED PLANT AND MACHINERY
PARTIAL REGULATORY IMPACT ASSESSMENT

1. This partial Regulatory Impact Assessment (RIA) updates the partial RIA published on 2 December 2004 along with a Technical Note on the Reform of Corporation Tax. These documents are available at www.hmrc.gov.uk/pbr2004/sup_ct-ria-leasing.pdf and www.hmrc.gov.uk/pbr2004/sup_ct-reform-tech-note.pdf respectively
2. In the 2004 Pre Budget Report it was announced that –
 - the tax treatment of leased plant and machinery would be reformed, and
 - legislation on these proposals will be included in Finance Bill 2006.
3. This updated RIA accompanies a further Technical Note on the taxation of leased plant and machinery that is available at <http://www.hmrc.gov.uk/leasing/>. The Technical Note explains that the new regime will commence on 1 April 2006 and gives further details of the regime and transitional rules.

THE OBJECTIVES

4. The current tax rules treat loan finance and leasing finance differently even though the commercial effect – that the business uses the asset while another party finances its purchase – may be virtually the same. 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.
5. 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.
6. 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 and by their nature function as financing transactions. However, some operating leases also function as financing transactions and these need to be identified if the policy objective of applying the new regime to leases that function as financing transactions is to be met.
7. 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 and so shorter leases will be excluded from the new regime. These shorter leases comprise the great majority of leases by number and excluding them will minimise the impact on business.
8. The policy objective of taxing leases that function as financing transactions in a similar way to loans will be achieved by taxing lessors and lessees on the basis of the substance of the transaction. Lessors will be taxed similarly to the way they would be had they made a loan and

lessees, the economic owners, will be treated as though they had acquired the asset and be able to claim capital allowances.

9. Leasing reform will allow the Government to remove current restrictions on overseas leasing in sections 109 and 110 Capital Allowances Act 2001 and relax the rules for allocating expenditure when an asset is acquired for finance leasing. These revised rules will however apply to a wider range of transactions as described below.

BACKGROUND AND OUTLINE OF NEW REGIME

10. The new regime will apply to leases of plant and machinery and to similar transactions that are properly accounted for as leases under GAAP.
11. As mentioned above, GAAP recognises two types of lease: finance leases and operating leases. In practice, leases of plant and machinery exhibit a range of characteristics that place them on a spectrum from pure financing transactions to short term operating leases. Consequently some leases that are classified as operating leases for accounting purposes are essentially financing transactions. The reform introduces a statutory definition to identify leases that function primarily as financing transactions. This definition covers 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 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. The tax timing advantage of capital allowances is usually small or non-existent for shorter leases and does not affect the decision to lease an asset rather than finance it via another route. Therefore new regime will not apply to:
 - leases of 5 years or less, and
 - leases of between 5 and 7 years where, on an annual basis, the lease rentals do not vary by more than 5% (after excluding variations linked to changes in interest rates and exceptional payments made at or before inception) and the residual value implied by the lease terms is no more than 5% of the fair value of the asset at the start of the lease.
13. A hire purchase transaction is a type of lease. Hire purchase transactions with lessees carrying on a qualifying activity (such as a trade¹) will not be affected by the reform. However, at present, the tax treatment of lessors depends on whether the activity is within the charge to corporation tax or income tax: a trade, for example, is not a qualifying activity if it is not within the charge to tax. Therefore it is proposed the tax treatment of lessors entering into hire purchase transactions with a lessee that would

¹ Section 15 Capital Allowances Act 2001 defines a qualifying activity as "a trade, an ordinary Schedule A business, a furnished holiday lettings business, an overseas property business, a profession or vocation, a concern listed in section 55(2) of ICTA (mines, transport undertakings etc.), the management of an investment company, special leasing of plant or machinery, and an employment or office, but only to the extent that the profits or gains from the activity are, or (if there were any) would be, chargeable to tax." In this context 'tax' means corporation tax or income tax.

be carrying on a qualifying activity were they within the charge to tax will be brought into line with the tax treatment where the lessee is within the charge to tax.

14. There will also be two changes to the rule for allocating expenditure to chargeable periods when an asset is acquired for finance leasing (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. This rule will be relaxed so that it only applies where the lessor does not use the group's normal accounting date.
 - currently these rules only apply to finance leases. From 1 April 2006 where the lease term is for more than 4 years the rules in section 220 will also apply to operating leases that are funding leases.
15. The second of these changes arises from changes to the provisions relating to the exclusion of shorter leases. Consultation responses indicated that policy objectives would be better served by excluding all leases of less than 5 years (previously 4 years), and excluding leases of 5 to 7 years (previously 4 to 6 years) where certain conditions are met. Extending the scope of section 220 will ensure that this wider exclusion will not have a distortionary effect.
16. 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 7 years.
17. The taxation of long funding leases will be dependent on their correct accounting treatment. Where a lease is a long funding lease:
 - 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. Capital allowances will be available to lessees rather than to lessors.
 - operating lessors and lessees will be taxed, in principle, in a similar way to finance lessors and lessee, though the detailed mechanism is different. As with finance leases, capital allowances will be available to lessees rather than to lessors.
18. In the absence of further measures the new regime might allow capital allowances to be claimed more than once in respect of what is essentially the same expenditure. Therefore the new regime will prevent a long funding lessee from claiming capital allowances if the lessor or any superior lessor (if there is one) is entitled to claim capital allowances.

19. A lessee who views a lease as a long funding lease will need to establish whether or not the lessor (or any superior lessor) is entitled to claim capital allowances. That is,
- if, as will normally be the case, the lessee establishes that lessor (or any superior lessor) is not entitled to capital allowances the lessee will be able to do so;
 - if, exceptionally, the lessee establishes that the lessor (or any superior lessor) is entitled to capital allowances the lease will be treated as a non-funding lease;
20. Where, exceptionally, a lessor (or any superior lessor) is not within the charge to corporation tax or income tax, then similar concepts will apply. The lessee will need to establish whether the lessor (or any superior lessor) would be entitled to capital allowances if within the charge to corporation tax or income tax.
21. In practice we anticipate that any necessary information will be made available to the lessee as a standard part of the lease documentation.
22. If the lessee cannot establish whether the lessor (or any superior lessor) is entitled to claim (or not entitled to claim) capital allowances the lease will continue to be treated as a long funding lease, but no capital allowances will be available.

RISKS

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

OPTIONS

24. 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.
25. Therefore the chosen 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.
26. Under the proposal, leases will be taxed in one of the following ways:
- the current regime will remain for most 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

27. HM Revenue & Customs 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.
28. 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.
29. As the focus of the reform 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.
30. Non-funding leases will be not affected by the proposal, and those longer funding leases that are affected could still be written, as the proposed new regime will tax them on the basis of their commercial substance.
31. Long funding lessees will benefit from capital allowances.
32. 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.
33. Comments are invited on any sectoral impact, positive or negative, that is not identified below.

SPECIFIC INDUSTRY SECTORS

Shipping and tonnage tax

34. Tonnage tax companies do not get capital allowances, but they can still benefit from them indirectly, by way of reduced rentals, when they lease ships. Without further action, the reform would impact on shipping companies that had elected for tonnage tax.

35. Lessors will be taxable under the existing regime where they lease directly, and in some cases indirectly, to a tonnage tax company.

PFI and Local Authorities

36. PFI projects often involve non-taxpaying end users and many contracts are constructed as composite trades where capital allowances are not in point. Furthermore very few PFI projects enter into leasing arrangements, or other transactions that are accounted for as leases. As such all, or almost all, PFI projects will be outside the scope of the reform. Any that are affected will see only a very modest impact.
37. Comments are invited if this understanding is considered to be incorrect.

Oil and gas

38. Minor consequential changes will be made to the rules on sale and leaseback of assets used in a ring fence trade and to the deductibility of financing costs in computing the supplementary charge on ring fence profits.

Rail

39. 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 of them, if not all, are likely to fall outside the scope of the new regime.

Air

40. 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.

Manufacturing

41. 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.

COSTS FOR A TYPICAL BUSINESS

42. 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 on the basis of the accounts or require relatively straightforward adjustments.
43. Where leases are affected it should usually be very straightforward to determine the category of a lease for tax purposes.

44. Where a lease is affected by the new regime lessors will need to establish a mechanism whereby they can inform lessees whether they (the lessors) are entitled to claim capital allowances (or would be if within the charge to corporation tax or income tax).
45. Long funding lessees will be treated in a way that, in most cases, is similar to the way in which hire purchase transactions are taxed under the current regime. As such, they are unlikely to see a significant increase in administration costs.
46. The Government would welcome views on the costs involved.

EQUITY AND FAIRNESS

47. The proposals will not affect a lease if a written contract has been entered into between a lessor and lessee before 1 April 2006 as a result of which the complete asset has been made available to the lessee before that date.
48. Transitional rules will allow some leases to be taxed under the existing regime even where they are entered into on or after 1 April 2006.
49. Prior to the new regime becoming law HMRC will publish further information on its web site in response to issues raised following publication of the Technical Note in July 2005.
50. At the time these changes become law HMRC will publish detailed guidance on its web site.

COSTS AND BENEFITS

51. In assessing the costs and benefits, it is noted that the following will be unaffected:
 - leases (of any type) entered into before 1 April 2006;
 - leases within the transitional rules;
 - most operating leases;
 - shorter funding leases excluded from the proposals.
52. Together these categories account for the vast majority of leases written by the asset finance and leasing industry.
53. There are currently no environmental or social cost impacts.

Benefits

54. 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 will be changed (paragraph 14 above) and this should reduce administrative and compliance costs and be a significant simplification for business.

Costs

Administrative Costs

55. 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

56. 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

57. 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

58. There has been consultation with the Small Business Service and representatives of small business. The general consensus was that the reform would have very little effect on small businesses.

59. 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

60. 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

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

COMPETITION ASSESSMENT

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

63. 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.

64. Other markets potentially affected by this change might be among those, which are users of leasing finance. As mentioned in paragraphs 27-41 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.

65. In view of these conclusions, a detailed competition assessment is not included here.

SECURING COMPLIANCE

66. 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 HMRC to check that the self-assessments of businesses are correct.

67. HMRC will publish detailed guidance externally and to its staff on these changes as appropriate. The guidance will be published on the HMRC web site.

CONSULTATION

Public Consultation

68. Following the publication of the August 2003 consultation document on the Reform of Corporation Tax, 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.

69. 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.

70. The Government welcomed the comments and used them to develop the regime proposed in the December 2004 Technical Note.
71. Following the publication of the December 2004 Technical Note a further series of consultation meetings was held with particular business sectors and industry representatives with a special interest in leasing and in the effect of reform on lessors and lessees. These consultation meetings continued after the formal consultation period ended in February
72. There were over 80 written responses to the December 2004 Technical Note. Many of those that responded have engaged in further informal discussion. These discussions have been very constructive and facilitated an understanding of the practical and technical aspects of the policy development.
73. 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 proposals in the Technical Note published in July 2005. In particular, the consultation process has informed:
 - the development of the transitional rules,
 - the refined definition of a plant or machinery lease,
 - the refined definition of long funding leases (including the exclusion for shorter leases), and
 - the exclusion for plant and machinery leased with property.

Consultation within Government

74. HM Treasury, the Department of Trade and Industry and Small Business Service have been involved. There has also been wide consultation within HMRC including policy, operational and technical teams.

MONITORING AND EVALUATION

75. These proposals 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.
76. As part of the consultation process the IHMRC will review the compliance cost predictions contained in this RIA and make the necessary changes when publishing the final RIA.

SUMMARY AND RECOMMENDATION

77. 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 relax the rules for allocating expenditure when an asset is acquired for finance leasing.

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