

REGULATORY IMPACT ASSESSMENT FOR LEASED PLANT AND MACHINERY (LEASING REFORM)

Introduction

19.1 This final Regulatory Impact Assessment updates the partial RIA published on 5 December 2005.

19.2 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 would be included in Finance Bill 2006.

19.3 Technical Notes that set out details of the new regime were published on 4 December 2004, 21 July 2005 and 5 December 2005. The Technical Notes and this Regulatory Impact Assessment are available at <http://www.hmrc.gov.uk/leasing/>.

Purpose and Intended Effect of Measure

The Policy Objectives

19.4 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 treatment, 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.

19.5 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.

19.6 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.

19.7 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.

19.8 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.

19.9 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 than before, as described below.

Background

19.10 The new regime will apply to leases of plant and machinery and to similar transactions that are properly accounted for as leases under GAAP.

19.11 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.

19.12 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'.

19.13 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.

19.14 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 (for example because it is carried on abroad).

19.15 Therefore it is proposed the tax treatment of lessors entering into hire purchase transactions with a lessee that would 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.

19.16 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

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.

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; and

- 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.

19.17 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, and excluding leases of 5 to 7 years where certain conditions are met. Extending the scope of section 220 will ensure that this wider exclusion will not have a distortionary effect.

19.18 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.

19.19 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; and
- operating lessors and lessees will be taxed, in principle, in a similar way to finance lessors and lessees, though the detailed mechanism is different. As with finance leases, capital allowances will be available to lessees rather than to lessors.

19.20 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.

19.21 A lessee who views a lease as a long funding lease and wishes to claim capital allowances 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; and
- 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.

19.22 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.

19.23 In practice we anticipate that any necessary information will be made available to the lessee as a standard part of the lease documentation.

19.24 If the lessee cannot establish whether the lessor (or any superior lessor) is entitled to claim (or not entitled to claim) capital allowances, or chooses not to claim capital allowances, the lease will be treated as though it were not a long funding lease and be taxed under the existing rules.

Rationale for Government Intervention

19.25 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.

Consultation

Consultation within Government

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

Public Consultation

19.27 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.

19.28 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.

19.29 The Government welcomed the comments and used them to develop the regime proposed in the December 2004 Technical Note. 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 2005.

19.30 There were over 80 written responses to the December 2004 Technical Note. Many of those that responded 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.

19.31 Further Technical Notes were published in July and December 2005 covering, in particular, the commencement and transitional rules, a refined definition of a plant or machinery lease, a refined definition of long funding leases (including the exclusion for shorter leases), and an exclusion for plant and machinery leased with property. There were over 60 responses to these Technical Notes. Several respondents have engaged in informal and constructive discussions that continue to facilitate the development of the new leasing regime.

19.32 The Government has welcomed the comments that it has received from business during the periods of consultation.

Options

1. Do Nothing

19.33 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.

2. Capital Allowances to lie with the Lessee

19.34 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.

19.35 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
1. 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
 2. 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.

Election

19.36 Companies will be able to elect for leases, other than leases of cars, that would otherwise fall outside the new regime to be treated as if they were within the new regime.

19.37 Where a company's accounts are an accurate approximation of the result that would be achieved on electing into the new regime then, subject to reaching agreement with HM Revenue & Customs, the company will be able to base its taxable profits on the profits shown by the accounts.

19.38 This option will decrease compliance costs and will be deregulatory because there would no longer be a need to make capital allowance claims and keep track of assets where a short life asset election had been made. It will also remove a distortion whereby lessors of short-lived assets suffer a tax-timing disadvantage.

Costs and Benefits

Business Sectors Affected

19.39 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.

19.40 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.

19.41 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.

19.42 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.

19.43 Long funding lessees will benefit from capital allowances.

19.44 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.

Green Technology

19.45 There is no evidence of a substantial amount of leasing of green technology.

19.46 Continuing to allow lessors of all green technology to claim enhanced capital allowances risked making the new regime unstable. Therefore the Government has decided to withdraw enhanced capital allowances from lessors, except where the leased asset is a low CO2 emission car or green technology leased as part of the lease of a building.

Shipping and Tonnage Tax

19.47 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.

19.48 Subject to certain conditions lessors will remain taxable under the existing regime where they lease qualifying ships directly, and in some cases indirectly, to a tonnage tax company.

19.49 To qualify for this exemption from the scope of leasing reform, the tonnage tax company, in addition to having strategic and commercial management of the ship in the UK, must be responsible for the operation of the ship and the ship must not be chartered out (leased out) for a period of more than 7 years.

PFI and Local Authorities

19.50 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.

Rail

19.51 The Government understands that in the short term 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.

Air

19.52 Not all aircraft are financed by UK lessors and airlines already make extensive use of non-UK providers of finance which means that there will be some impact on airlines' costs of obtaining aircraft, the Government believes this will not be significant.

Oil and gas

19.53 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.

Manufacturing

19.54 There will be no significant impact on manufacturing. Any impact is likely to be limited to firms with tax losses persisting over several years, where they may be a small increase in cost of capital – but only if they choose to use leasing to finance new plant and machinery with relatively long life (i.e. typically heavy plant).

Property

19.55 Buildings such as offices and retail premises generally include items of plant or machinery such as central heating, air conditioning and lighting. In general, leases of such property are not financing transactions and the leasing of the plant or machinery within such property is incidental to the lease of the property itself.

19.56 The Government has accepted that it would not be appropriate to bring leases of such plant and machinery within the scope of the new regime. Therefore the new regime will not normally apply where plant or machinery is leased as an incidental part of a typical property lease.

19.57 The type of plant or machinery that will be excluded is that which is incidental to the occupation of the building, such as electrical, heating and air conditioning systems. However, the exemption will not be defined by reference to type of building and so it will extend to similar plant or machinery, in whatever type of building or structure it may be found.

Benefits

19.58 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; and

- the scope of the allocation rule will be changed (paragraph 19.16 above) and this should reduce administrative and compliance costs and be a significant simplification for business.

19.59 If a company elects into the new regime and produces accounts that approximate the effect of the new regime there would be a saving in compliance costs for some lessors because the need to produce capital allowance computations would be reduced.

Costs

19.60 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; and
- shorter funding leases excluded from the proposals.

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

Costs for a typical business

19.62 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.

19.63 Where leases are affected it should usually be very straightforward to determine the category of a lease for tax purposes.

19.64 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).

19.65 Where a lessee does not want to come within the new regime (and so claim capital allowances) there will be no change from the present situation. It is anticipated that this will be the case with the vast majority of lessees.

19.66 Where a lessee wishes to come within the new regime it 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. Lessees will, however, need to determine whether or not they are prevented from coming within the new regime by the lessor (or a superior lessor) being entitled to claim capital allowances. The Government expects that this information will be provided to them by the lessor and, as such, they are unlikely to see a significant increase in administration costs.

19.67 There will be costs to lessors who need to update or revise their computer software to be compliant with the new regime. This cost should be small in relation to the size of the business. In addition lessors will need to train staff in use of the new software and the products available as a result of the new regime.

19.68 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.

HM Revenue and Customs Costs

19.69 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

19.70 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 £60m, 2007 / 08 £150m.

Equity and Fairness

19.71 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.

19.72 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. Prior to the new regime becoming law, HMRC published further information on its web site in response to issues raised following publication of the Technical Note in July 2005. At the time these changes become law HMRC will publish detailed guidance on its web site.

Other Impacts

Devolution

19.73 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, Social Costs, E-Policy, Environmental Impact, Rural Proofing

19.74 Currently there are no impacts on human rights, social costs, e-policy, environmental impact or rural proofing as a result of this proposal.

Small Firms Impact Test

19.75 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.

19.76 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.

Competition Assessment

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

19.78 Other markets potentially affected by this change might be among those, which are users of leasing finance. As mentioned in paragraphs 19.39 to 19.54 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.

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

Enforcement, Sanctions and Monitoring

19.80 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.

19.81 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. Initial guidance on key aspects of the new regime will be available in early April, with additional guidance published in July.

Post-implementation Review

19.82 These proposals will contribute to the Government's balancing of competitiveness and fairness in taxation. The changes will be kept under review to see how they are working in practice.

19.83 The compliance cost impacts from the changes to the regime will be reviewed as part of HMRC's ongoing compliance cost review programme. In due course HMRC will also undertake a review of the figures in this RIA in Standard Cost Methodology terms.

Implementation and Delivery Plans

19.84 No additional obligations to submit returns, reports or co-operate with inspections arise.

19.85 The legislation imposes the following additional administrative requirements:

- Lessors wishing to claim capital allowances will need to ensure that their records allow them to establish that the leases in question are not long funding leases; and
- A lessee wishing to claim capital allowances under a long funding lease is required to ascertain whether or not the lessor is claiming capital allowances. The Government expects that this will be met by adding an appropriate clause in the lease documentation. The costs of this will be marginal once the necessary systems changes have been implemented.

19.86 A lessee or lessor wishing to be taxed in accordance with the new regime will be able to elect in to the new regime. There is no required form of election although certain information will need to be provided. The cost of making such an election will be insignificant.

19.87 Once the transitional phase is over it is not expected that there will be any significant difference in the administrative burden imposed by the new regime compared to the existing regime.

Summary and Recommendation

19.88 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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REGULATORY IMPACT ASSESSMENT
Leased Plant and Machinery (Leasing Reform)
Statement of Ministerial Approval

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

Dawn Primarolo
Paymaster General

Dated: 15 March 2006