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Equipment Leasing

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1. INTRODUCTION

In simple terms, equipment and other specialised asset leasing involves rentals being paid for the use of the asset concerned by the user (the lessee) to the owner (the lessor).

This type of leasing has its origins in the supply of equipment on short-term rental or hire. This practice is continued today by car hire companies and firms which hire out specialist tools and equipment. In all such cases, the lessor's basic attribute is the ability to control and manage a pool of assets available for use by a series of lessees over time. With an operating lease of this nature, the lessor comes to the lessee because the lessor is able to provide the asset concerned.

This article deals principally, however, with a different form of leasing, namely finance leasing. Finance leasing has grown over the past 35 years or so into one of the most important methods, in the UK and elsewhere, for financing the acquisition of capital assets. A lessee embarking on a finance lease is looking to the lessor to provide finance for an item of equipment which the lessee may already own or will certainly have made arrangements to acquire. The lessor is not expected to have any experience in the acquisition, management or disposal of the assets concerned. All those matters will be handled by the lessee. All the lessor is required to do is to take title to the assets and come up with the necessary cash. The tax saving that the lessor is expected to derive from any capital allowances available in respect of the assets will be factored into the lease rentals to produce a lower cost of funds to the lessee than non-lease finance.

Subject to that, however, a finance lease is to all intents and purposes a secured loan with tax advantages. So long as the lessee pays the rent, the lessor will get its investment back with a healthy return and will never have to deal with the physical aspects of asset management. The assets will remain under the control of the lessee from the date of purchase until the date of sale.

Notwithstanding various changes to the tax rules over the years, including a lowering of the rate of capital allowances, these basic elements of finance leasing remained in place until the end of the long consultation process that culminated in a complete overhaul of the system with the enactment of FA 2006. The Government's stated objective was to remove a 'distortion' inherent in the old system by ensuring that an asset financed by way of lease would be treated in broadly the same way as an asset purchased with a loan. In the future, therefore, capital allowances will not be available to lessors under finance leases (except for those which are short-term leases and for certain ship leases). Instead, the lessee will be entitled to allowances. This fundamental change to the

tax system is likely to bring to an end most big ticket finance leasing in the UK. The background to this reform is discussed in more detail in 4 below.

2. FINANCIAL IMPLICATIONS OF LEASING

Before addressing in some detail the scope of the tax reforms introduced in 2006, it is important to understand the economics of traditional finance leasing. Every business which draws up accounts will provide in those accounts for the inevitable depreciation in value of the capital assets used in the business. If, for example, a company pays £10,000 for a new machine which has an estimated useful life of ten years after which it is expected that the machine will have to be sold for scrap, then it is entirely logical that accounting conventions should require the company to write off the £10,000 over the ten year period in determining its profits for each year comprised therein. The £10,000 spent on the machine is just as much a cost of earning income for the company as its rent, rates, salaries and other recurring overheads. Deciding how that write off should be taken – at what rate per annum and over what period – is a matter for agreement between the company and its auditors but the basic principle remains unaffected.

Since corporation tax is a tax on profits and the amount of the income or revenue profit subject to tax is, in the first instance, taken from the taxpayer's commercial accounts, it would not be illogical to expect the accounting depreciation figures to be accepted for tax purposes as well. This, however, would produce a lack of uniformity between taxpayers carrying on broadly the same business with the same capital asset requirements. Not everyone adopts the same basis of accounting depreciation. Some tax systems solve this problem by having statutory lists of types of business assets with a permitted depreciation schedule for each. The UK system is less selective and, ignoring for the moment the special rules for 'long-life' and certain other assets, adopts the simple expedient of allowing only one rate of depreciation (currently 20% writing-down allowances on the reducing balance) for all classes of assets. This is a rough and ready substitute for accounting depreciation which has to be disregarded in preparing tax computations. It is, therefore, a compromise which makes tax administration much easier.

The 'across the board' first-year allowance, which was largely responsible for the development of the modern leasing industry but was abolished with effect from 1 April 1986, fell into a different category. It was first introduced in 1970 at a rate of 60%. The clear object of its introduction – at a time of rapidly developing technology – was to provide an incentive for industry to invest in new capital assets resulting from that technology. The theory, which appears to have worked in practice, was that if you allowed substantial tax deductions when investment was made in plant or machinery, you would encourage such investment. Thus, in 1971 the allowance was increased to 80% and in 1972 it reached 100%. There it remained (for most plant or machinery) until the 1984 Budget, when the basic strategy was reversed. Unemployment was high, and the tax system was perceived to be encouraging capital investment at the expense of full employment.

Allowing a business to write off the whole of the cost of a new machine, ship, computer, aircraft etc. in the year of acquisition clearly had nothing to do with finding the right level of taxable profits by adjusting the accounts depreciation. Accounts depreciation was bound to lag far behind tax depreciation and leave companies with novel accounting problems for coping with this disparity. The first-year allowance was a clear investment subsidy through the tax system.

The theory of that was fine for taxpayers. They knew that capital investment would result in their paying less tax to the government at the end of the year and could plan accordingly. Some of the UK's most capital intensive industries had, however, been hit hard by the world recession as oil prices increased and also by increasing foreign competition. As a result, they were in a tax loss position. More tax relief on capital investment was worth nothing

to them since they would not have been paying tax in any event. Ironically, however, they were among the industries that the government wanted to do most to help. Banks and other financial concerns remained heavy tax profit makers as did other companies which were more service oriented and less capital intensive.

Leasing was the means by which this imbalance in the tax system was corrected. Every business which was about to make a capital investment needed finance. Banks were the obvious source for this but if a company which was in a tax loss position and expected to be so for some years simply borrowed the money to buy the asset, the benefit of the first-year allowance would be wasted. The easy solution, as the banks had plenty of tax capacity (taxable profits to shelter), was to get the bank to buy the asset and lease it to the company concerned. Then the bank would get the benefit of the first-year allowance and could use it to reduce the effective cost of finance to the lessee.

At this stage some alterations had to be made to the basic concept of equipment leasing. Banks did not want to take the normal risks of ownership that any normal equipment lessor would take. The bank wanted to do the minimum necessary consistent with providing finance and obtaining capital allowances. It certainly did not want to end up relying on being able to re-let the asset or sell it at a particular price at the end of the lease in order to recoup its investment. At the same time, the bank's customers did not want the bank interfering with the way in which they managed their assets. Nor did they want to pay the bank more than they would have done on conventional loan finance (after taking account, of course, of the benefits the bank obtained from the capital allowances). Out of these equal and opposite commercial objectives, finance leasing was born.

Finance lease rentals are, therefore, calculated on a completely different basis from operating lease rentals. The prime object is to enable the lessor to get its money back with interest after allowing for the capital allowance benefits. With a 100% rate of first-year allowance and a 52% (or, for ease of illustration, 50%) tax rate as subsisted up to the 1984 Budget the basic mathematics are easy. The bank spends £10,000 to buy the asset which it leases to the lessee. The tax saved is £5,000 so the annual cost to the lessor of financing its *net* investment has to be interest on that reduced figure (not the full £10,000). Ignoring interest and other finance charges, the bank needs 10 annual rentals of £1,000 to get its own £5,000 back. Of each £1,000 that comes in, £500 goes in tax so, at the end of the day, the bank has got its £5,000 back and HMRC have got their £5,000, albeit not in one lump sum in year 1 but in 10 equal instalments over years 1 to 10. The cash flow cost to HMRC is matched by a corresponding cash flow advantage to the bank, and it shares this with the lessee. With the current writing-down rates of capital allowances (now generally 20% per annum) and a 28% corporation tax rate, the mathematics are a bit more difficult but the basic principle of subsidised finance through tax deferral remains the same.

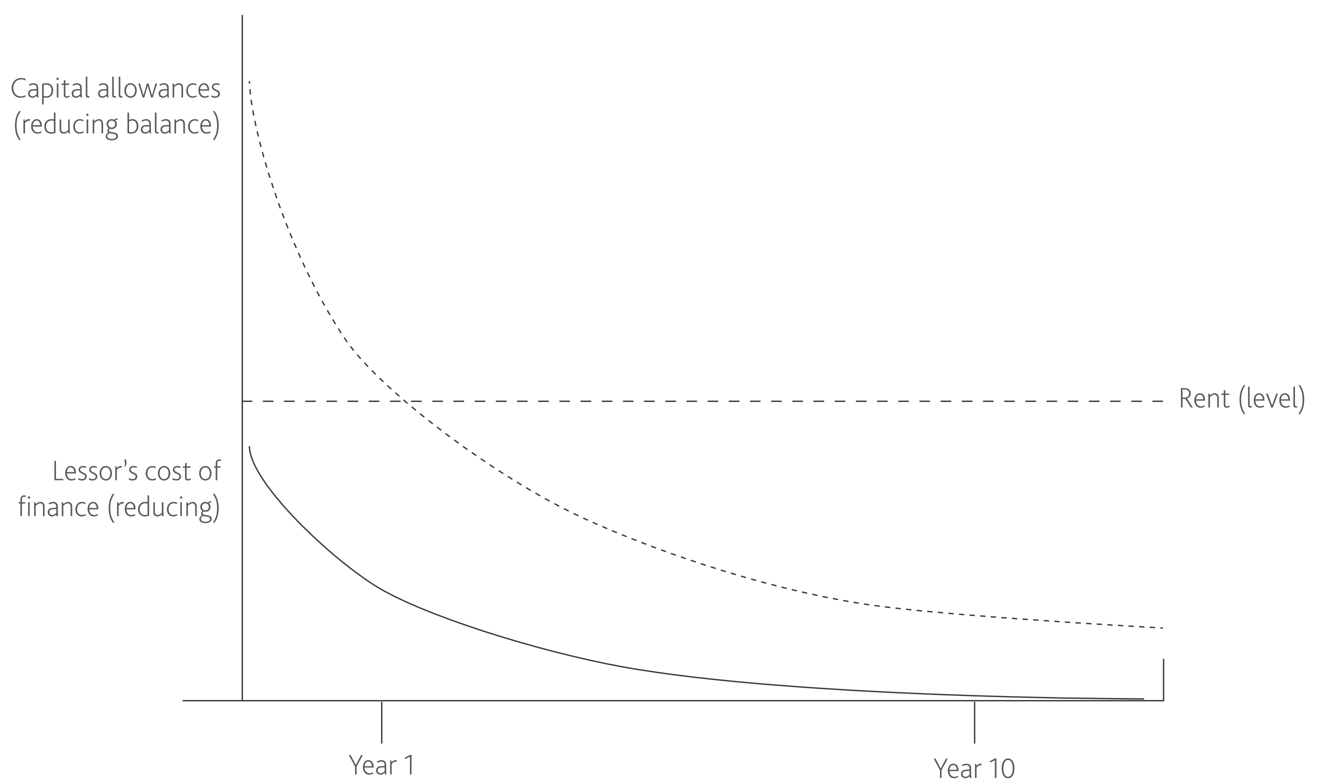
Any bank entering into a finance lease as lessor is, as already mentioned, only acquiring the asset to provide a financial facility as an alternative to conventional loan finance and it is, therefore, concerned to ensure that the documentation contains suitable indemnities holding it harmless against risks and other costs of ownership. The bank is also prepared to give up by far the greater part of the residual value of the asset to the lessee (see the description of the tax aspects of termination at 35 below). Economically, the bank wants to be in no worse, and preferably a much better, position than it would have been in if it had made a loan. Returns on traditional finance leases, although not as high as they used to be, have remained better than returns on conventional loans.

By the same token, the lessee wants to see the benefit of the capital allowances which it is giving up reflected in cheaper finance. If, in the above example, the lessee had simply borrowed £10,000 from the bank and bought the asset itself, it would have derived no benefit in net present value terms from the first-year allowance and would have been paying interest to the bank on a full £10,000 (not the net after-tax £5,000 the bank invests in the lease). Finance leasing could be described – rather cynically and simplistically – as a loan with tax frills attached, where the bank gets tax relief for making the loan but, by the same token, has to pay tax on capital repayments. Every lessee knows, however, that finance leasing is not as easy as that and that certain of the advantages and liberties

of ownership have to be given up. Some companies for whom finance leasing would have made perfect economic sense have refused to go into it for these very reasons. For other companies, the benefits have been marginal or non-existent because, although not immediately tax profitable, they were expecting to be so not long after the asset was to be bought and could carry forward the unutilised tax relief until then.

To put some simplistic figures to this basic illustration, however, it can be seen that, if the general level of interest rates is around 12%, a lessor could earn 16% p.a. on the funds which he had to provide from his own resources (£5,000) while offering the lessee finance at approximately 8% p.a. on the overall facility (£10,000). This illustrative 4% margin for the lessor and 4% saving to the lessee provide an indication of why leasing is attractive to both lessor and lessee and show how banks could turn their tax capacity into a valuable asset. Market forces then had their inevitable effect on leasing margins and the cost of leasing facilities went up and down within a broad band as tax capacity was in greater or lesser supply. Of course, now that capital allowance rates and tax rates are lower, the financial benefits of leasing are not so great.

The extent to which a lease financing will generate tax deferral (and so a lower effective financing rate for the lessee) can be illustrated as follows:



In year 1, the aggregate of the first year's capital allowance claim and lessor's finance charges for that year is greater than the rent received. The net result is a tax loss (or tax deferral) for the lessor.

In year 10, the reverse is true. As the capital expenditure balance on which allowances are claimed has reduced and lessor funding has been paid down with a consequent reduction in annual finance charges, rental income has gone above the aggregate of these two. On the basis of this notional single asset transaction, tax is thus due for year 10.

The picture, therefore, is one of tax being deferred in the early years of the lease and paid in the later years. The higher the initial capital allowance rate, the more there will be tax savings above the line in year 1. If rental payments can be deferred until the asset in question has been built and brought into use and/or set at levels which increase (on an upward curve on the graph) from year to year, the above the line benefits will be correspondingly greater.

A low interest and tax rate environment and reducing initial capital allowances have thus not been good for lease economics (especially when coupled with rules designed to accelerate the tax recognition of rental income); and this trend has been perpetuated by the various reductions in rates over recent years, with the main rate of corporation tax being scheduled to decline to 24% by April 2014 and the general rate of writing-down allowance for plant and machinery falling from the current 20% to 18% in respect of periods ending on or after 1 April 2012.

Reductions in tax rates over the life of a lease can obviously have a positive effect on lease economics. Income on which tax has not been paid in early years will effectively be taxed at the lower rates prevailing in later years as a result of the lease deferral. Sadly, however, the reverse is true if tax rates go up.

The timing and rate of capital allowances, the rate of tax, the cost of finance and the basis on which rents have to be recognised are thus the key economic factors in determining lease rates and the value of a leasing transaction to lessor and lessee alike.

These matters (along with a number of other tax and financial aspects) are usually dealt with by complicated rental adjustment provisions (see 39 below) although (*a*) it is not uncommon for lessors to write fixed rate leases where they take the risk and accept the benefit of interest rate movements for themselves and (*b*) it is not unknown for lessors to do deals with no tax adjustment provisions. In both cases, however, one would usually find that the lessor was taking a higher return as an insurance premium against the increased risks it was taking. This has tended to be reserved, therefore, for smaller value transactions.

As a general principle, lessors earn their return on an after tax and finance costs basis. They are thus insulated from adverse changes but have to give up (by reducing the rent) beneficial ones.

From a lessee's standpoint, accepting interest rate adjustment provisions puts it in the same economic position as it would have been in if it had borrowed money at a rate of interest fluctuating with market rates from time to time. Taking the risk and accepting the benefit of tax changes, however, raises different considerations. There the lessee is taking a risk which it would not have had to run with a straightforward loan. If, to take an easy example, by the time lease rentals start to flow tax rates have increased to 75%, only one quarter of what the lessor receives will be available to pay off its investment. If, on the other hand, tax rates go down, correspondingly more will be available to pay off the lessor's investment. In the first case the rent will have to go up if the lessor is to be paid out and its return maintained; in the second case the rent can safely be reduced and the lessor will still be paid out and adequately compensated.

Lessees who decided – or were forced in the absence of a commercial alternative – to have tax adjustment provisions in their pre-1984 leases benefited considerably from the reduced corporation tax rates announced in the 1984 Budget because 100% allowances had been taken at tax rates higher than those which would apply to the rental recapture. Now, however, the position would be more balanced because the claiming of allowances is spread over a longer period and so a lease may be tax-loss generating for a number of years. Moreover, the effect of tax adjustment provisions will inevitably be somewhat less advantageous to the lessee where a reduction in the main rate of corporation tax during the term of the lease is accompanied by a reduction in the general rate of plant and machinery allowances (the precise combination of changes that took effect from April 2008).

If a lease terminates early – whether voluntarily or by reason of default or insured loss – a termination payment will need to be made to retire the outstanding investment. The way in which termination payments are calculated varies from lessor to lessor. A detailed cash flow calculation is usually much more accurate than discounting future rentals or taking figures off a table set at the outset. See also 35 below.

3. THE ACCOUNTING TREATMENT

There are many publications available which deal in detail with the accounting treatment of leasing transactions. The basic accounting text, however, is SSAP 21, which came into effect in August 1984 (and now see also IAS 17). As will be seen, the basic approach for lessees is to treat full pay-out finance leases as loans. This treatment is fundamental to the major tax reforms introduced in 2006 and discussed below.

4. IMPETUS FOR TAX REFORM

Notwithstanding the fundamental difference between the accounting treatment of finance leases and that of operating leases, there was for a long time virtually no difference in tax treatment between the two.

Gradually, during the 1990s, distinctions were introduced. Initially, the main focus of these changes was to go some way towards aligning the tax treatment of rental payments with the accounting treatment – see, for example, the rules governing the tax treatment of finance lessors' returns introduced in 1997 and now set out in CTA 2010, Pt 21 (accelerating the tax recognition of rental income). One obvious aspect of these changes was to ensure that the 'tax deferral' benefits of finance leasing did not become too excessive. Further changes were then introduced to the tax treatment of finance leasing in order to deal with perceived abuses, such as the various rules governing the tax treatment of sale and finance leaseback arrangements. At this stage, however, there was no deviation from the basic principle that tax ownership of the relevant asset should remain with the finance lessor.

Subsequently, however, the Government became even more concerned that finance leasing was being (or might be) used as a vehicle for tax avoidance activities. This could be seen not only in the more recent legislative reforms but also in high profile litigation involving, amongst other things, defeasance arrangements and non-resident lessees. At the same time, the statutory rules governing leasing to non-residents (the 'overseas leasing' rules) became a particular source of concern to HMRC. These rules restricted the capital allowances available to lessors in respect of assets leased to lessees outside the UK tax net, the theory being that UK tax benefits should not be used to provide subsidised rentals to those who are not UK taxpayers. The difficulty for HMRC was that it became increasingly likely that the overseas leasing code would at some stage be challenged on the basis that it was not compliant with European Community law. The temptation to reform the whole system and transfer tax ownership to finance lessees therefore became somewhat overwhelming.

Thus, ever since the publication of the government's consultation paper on corporation tax reform (in August 2003), it was clear that the ownership (for capital allowance purposes) of plant or machinery leased under a finance lease might well be moved from the lessor to the lessee (thus matching the accounting position). In addition to addressing the specific issues mentioned above, the broad effect would be to remove the fundamental distinction, from a tax viewpoint, between lease finance and loan finance (and thus, in the government's eyes, to eliminate a basic 'distortion' inherent in the old system). The finance lessee would be entitled to capital allowances – just as if it had itself purchased the equipment using borrowed funds – and the lessor would be taxed only on the finance charge element of the rentals (with the lessee being entitled to corresponding relief). As it has turned out, these major changes were introduced by FA 2006.

Two particular points emerged at a very early stage in the consultation process.

(1) From HMRC's perspective, the accounting distinction between finance leases and operating leases was somewhat inadequate for the purpose of this fundamental reform of the system. This was because there were some leasing transactions that could be accounted for as operating leases but were essentially financing transactions with many of the features typically associated with finance leases. These would have to be brought within the scope of the reforms and treated in the same way as finance leases. Hence the concept of a 'funding lease' was born.

(2) However, HMRC recognised that there was no particular reason why leases of a relatively short duration needed to be subject to these reforms. As a matter of general principle, funding leases with a term of, say, four years would not produce significant 'tax deferral' benefits and there was therefore no compelling policy reason why capital allowances should not continue to be available to the relevant lessor. Accordingly, the reforms do not apply to leases with a duration of five years or less (or, in certain cases, of seven years or less) and the finance leasing industry can therefore continue to undertake activity in this area in broadly the same way as in the past.

It must be emphasised, however, that neither of these points is of enormous significance to big ticket finance leasing where, typically, the lease in question will be a finance lease for accounting purposes and the term of the lease will be greater than seven years. Tax-based leasing of this nature will be subject to the reforms introduced in 2006 and so will not be viable in the future, except to the extent that it is grandfathered under the transitional rules or one of the limited exceptions applies (most notably in the case of leasing to tonnage tax companies).

5. AMBIT OF FA 2006 REGIME

The relevant changes introduced by FA 2006, Sch 8 are of such significance to the leasing industry that the scope of these reforms will be addressed before the rules governing the traditional system are considered in detail (and reference may also be made to HMRC's 'technical note' on Leased Plant and Machinery dated 1 August 2006, which provides further explanation).

The most critical feature of the new regime is that a lessor which enters into an equipment lease within the ambit of this regime will not be entitled to any capital allowances in respect of expenditure incurred on the provision of such equipment (CAA 2001, s 34A). The lessee, if within the UK tax net, will be entitled to allowances but, to achieve this result, it could have purchased the asset itself (if necessary, financed by a loan). Accordingly, the overall financial benefits of traditional equipment leasing (described in 2 above) will not be available.

It follows that, in the context of this article, the key issue in the case of any leasing proposal is going to be whether or not the relevant lease will be within the ambit of the new regime. A lease will be within the ambit of this regime if it is what is described in the legislation as a 'long funding lease' and this concept is defined in considerable detail in CAA 2001, Pt 2 Ch 6A. The approach adopted in the legislation is, first, to describe what constitutes a 'funding lease' (see CAA 2001, s 70J). It is then necessary to refer back to s 70G to discover that a funding lease will constitute a 'long funding lease' unless it is excluded from doing so on one of a number of grounds.

6. Funding lease

By virtue of CAA 2001, s 70J, a funding lease is a plant or machinery lease which at its inception meets one of three tests. For this purpose, there is a broad statutory definition of 'plant or machinery lease' (s 70K). The point to be noted here is that the arrangement must be accounted for as a lease under generally accepted accounting practice

or, alternatively, the lease must be a finance lease of plant or machinery comprised within a sale and finance lease-back (as defined in CAA 2001, s 221). The specific inclusion of sale and finance lease-back arrangements – by virtue of s 70K(1)(*c*) – appears to be necessary because the lease-back may be accounted for as a loan (and not a lease) but, unhelpfully, the relevant drafting is somewhat obscure.

The ‘inception’ of a lease will generally be the earliest point at which there is an unconditional written contract for lease between the parties and no terms remain to be agreed. Where the relevant contract is conditional, ‘inception’ will arise once the conditions have been met. The three critical tests (one of which must be satisfied for the lease to be a funding lease) are:

(1) by virtue of s 70N, that the lease is one which, under generally accepted accounting practice, falls (or would fall) to be treated as a finance lease or a loan in the relevant accounts (the ‘finance lease’ test);

(2) by virtue of s 70O, that the present value of the minimum lease payments (see further below) is equal to 80% or more of the fair value of the asset (the present value being calculated by using the interest rate implicit in the lease) (this being the ‘lease payments’ test); or

(3) by virtue of s 70P, that the term of the lease is more than 65% of the remaining useful economic life of the asset, as defined in s 70YI (the ‘useful economic life’ test). The remaining useful economic life is the period beginning with the commencement of the term of the lease and ending when the asset is no longer used (and no longer likely to be used) by any person for any purpose as a fixed asset of a business.

It will be seen, therefore, that – as mentioned in 4 above – the lease in question will be either a finance lease (or loan) pursuant to the first test or it will be an operating lease incorporating at least some characteristics normally associated with finance leases.

For the purpose of the lease payments test, the concept of ‘minimum lease payments’ is defined in s 70YE (and see also s 70YD). In principle, the minimum lease payments are the minimum payments under the lease over its entire term (after deducting amounts in respect of indirect taxes such as VAT) together with – in the case of the lessor – so much of any residual amount as is guaranteed by the lessee or a person not connected with the lessor. In this context, a residual amount is so much of the fair value of the asset as cannot reasonably be expected to be recovered by the lessor from the payments under the lease.

7. Leases which are not funding leases (and are thus outside the scope of the new regime)

By virtue of s 70J(3), a lease is not a funding lease if CAA 2001, s 67 applies and the lease is the contract referred to in that section. As discussed further in 18 below, s 67 may deem an asset to be owned by a person once that person has incurred capital expenditure under a contract providing that title to the asset will or may pass at some point in the future (such as a hire purchase arrangement). The point is that, in this instance, the asset is in any event treated as owned by the hirer rather than by the legal owner, so that there is no need for the leasing contract to be brought within the FA 2006 regime. Where, however, the hirer enters into a further lease of the relevant asset which is unaffected by s 67, such further lease will be capable of constituting a funding lease. If it is a long funding lease, the hirer (the intermediate lessor) will not be entitled to allowances.

By virtue of s 70J(4), a lease is not a funding lease if, prior to the commencement of the lease term, the relevant asset has been leased under one or more other leases, the aggregate terms of which exceed 65% of the remaining useful economic life of the asset at the commencement of the term of the earliest such lease (provided that none of those earlier leases was itself a funding lease). In addition to this, s 70J(6) provides that a lease will not be a funding lease (in the case of the lessor) if, prior to 1 April 2006, the asset had been leased out under one or more

leases for an aggregate period of at least ten years and the lessor under the lease in question was also the lessor of the asset on the last day before 1 April 2006 on which the asset was the subject of a lease. Taken together, the separate rules in sub-sections (4) and (6) of s 70J appear to be intended to ensure that, where plant or machinery has been the subject of a series of leases, a lease entered into towards the end of the asset's useful life will not be a funding lease merely by virtue of the 'useful economic life' test described in 6 above.

8. Long funding lease

A funding lease will be a *long funding lease* (and thus within the ambit of the new leasing regime) unless one of the following exclusions applies.

(a) Most importantly, a lease – even if it is a funding lease – will not be a long funding lease (and will thus be outside the ambit of the FA 2006 regime) if it is a short lease. The concept of 'short lease' is defined in CAA 2001, s 70I and is intended to cover leases of relatively short duration which, by their nature, do not give rise to material 'tax deferral' benefits (see 2 above). The rationale for the exclusion of such leases from the new regime is that tax considerations will not have played a significant part in the decision to raise finance by way of lease rather than by way of loan.

The basic rule is that any lease with a term of five years or less will be a short lease. Where the term of a lease is longer than five years but not longer than seven years, the lease will be a short lease only if it is a finance lease (as an accounting matter) with broadly level rental payments over the lease term and under which the implicit residual value of the leased asset is no greater than 5% of its market value at the commencement of the lease term (the latter requirement being intended to ensure that the lease rentals repay virtually the entire 'principal' amount of the lease financing). A provision has been included in s 70I(9) to ensure that a transaction that would otherwise be a long lease cannot be artificially fragmented into a series of short leases to persons who are connected with each other.

Not surprisingly, there follow some detailed rules defining the 'term' of a lease: see in particular s 70YF and also s 70YC. For example, where the lessee has an option to continue to lease the asset for a further period and it is reasonably certain that this option will be exercised, the term of the lease will include such further period. The detailed provisions are, therefore, intended to ensure that a lease which would not otherwise be a short lease cannot be artificially structured as a short lease by the incorporation of renewal options or by other similar techniques (and see, in particular, the anti-avoidance rule in sub-sections (5) to (7) of s 70YF).

(b) A lease will not be a long funding lease if it is an excluded lease of 'background plant or machinery for a building' (see ss 70R–70T).

The intention behind this rule is to exclude from the new regime plant or machinery leased as an incidental part of a typical real property lease, so that the landlord under such a lease will remain entitled to capital allowances. It is provided that the background plant and machinery for a building is any plant or machinery which is of such a description that an asset of that description might reasonably be expected to be installed in or on the sites of a variety of buildings of different descriptions and whose sole or main purpose is to contribute to the functionality of the building or its site as an environment within which activities can be carried on (obvious examples would be lifts and central heating installations). This definition has been supplemented by the Capital Allowances (Leases of Background Plant or Machinery for a Building) Order 2007, SI 2007 No 303, which lists:

(i) examples of assets that fall within the definition;

(ii) assets that will be deemed to fall within the definition; and

(iii) assets that may not be treated as falling within the definition.

Anti-avoidance provisions are included in s 70S.

(c) There is also a de minimis exclusion (from the new regime) for plant or machinery which is leased with land but does not constitute 'background plant or machinery' for a building (see s 70U). In essence, for this exclusion to apply, the market value of the relevant item or items of plant or machinery must not exceed both 5% of the market value of the land (including buildings and fixtures) and 10% of the aggregate market value of any 'background plant or machinery' leased with that land.

(d) Of much greater significance to equipment lessors is a further exclusion in respect of leases of qualifying ships to tonnage tax companies. Such leases will not be long funding leases (whatever the term of the lease). This is another example of the special treatment that has consistently, over many years, been afforded to investment in ships and it is one area where traditional finance leasing activity is likely to continue. This key exclusion is discussed in detail in 24 below.

9. Deemed long funding lease: international leasing

An anti-avoidance rule has been included in s 70V with the stated objective of ensuring that allowances will not be available to an intermediate UK lessor which takes equipment on lease (a long funding lease) from a non-resident and then leases it back out to another non-resident (by way of a lease which would not otherwise be a long funding lease) in order to obtain the benefit of UK capital allowances. This rule appears to be intended mainly to prevent an offshore leasing arrangement being 'routed' through the UK in order to secure UK allowances, the benefit of which is then (for the most part) passed to the non-resident lessee. This is achieved by deeming the lease out of the UK by the intermediate UK lessor to be a long funding lease. It is important to appreciate that the rule will apply only where the superior lessor is a non-resident (as opposed to a UK person in whose hands the rentals would be taxable in the UK).

The difficulty with this provision is that its application hinges on a motive test. In essence, s 70V applies where plant or machinery is leased by a non-resident to a UK resident under a lease which is a long funding lease (or one to which CAA 2001, s 67 applies) and then in turn leased to a non-resident under a lease that would not otherwise be a long funding lease, in circumstances where the sole or main purpose of arranging matters in this way is to obtain a tax advantage by securing plant or machinery allowances for the UK resident. Where applicable, the lease by the UK resident will be deemed to be a long funding lease, so that allowances will be denied to that person. HMRC have stated, by way of example, that s 70V will not deny allowances to a UK lessor entering into a short term operating lease of an aircraft to an overseas airline in circumstances where the lessor financed its acquisition of the aircraft by way of a long funding lease from a non-resident manufacturer. However, this conclusion can be based only on the judgment that the sole or main purpose of such arrangements was not to secure UK allowances because, in all other respects, the requirements of s 70V are satisfied.

10. Commencement and transitional rules

The following is an overview of the complex commencement and transitional provisions. The main rules are set out in FA 2006, Sch 8, para 15(1)–(3) and para 21. The complexity of these rules and a certain lack of coherence are, to a large extent, due to the way in which the rules were continually adjusted during both the initial consultation process and the passage of the Finance Bill.

(a) The FA 2006 regime (including all the rules introduced by Sch 8 governing the treatment of 'long funding leases') will *not* apply to any lease that was finalised before 21 July 2005 (provided that the lessor was within

the charge to tax on 17 May 2006) (FA 2006, Sch 8, para 15(1)). In essence, a lease is treated as finalised either on the date on which the parties enter into an unconditional agreement for lease or, where a conditional agreement for lease has been entered into, at the time when the conditions have been satisfied. This assumes that the relevant agreement is in writing and that no terms remain to be agreed (Sch 8, para 23).

(b) Subject to the grandfathering rule in (a) above, the FA 2006 regime *will* apply where the relevant lease is finalised on or after 1 April 2006 or, even if the lease was finalised at an earlier date, the commencement of the lease term is on or after that date. 'Commencement' is defined in CAA 2001, s 70YI by reference to the date from which the lessee is entitled to use the complete leased asset. However, this rule is subject to an exception for assets under construction before 1 April 2006 in circumstances where heads of agreement were in place before 21 July 2005. For this exception to apply, the general requirement is that the lease must be finalised, and the lease term must commence, before 1 April 2007. However, where certain detailed conditions are satisfied, this requirement may instead be satisfied before 1 April 2009.

The legislation naturally sets out what is meant by 'heads of agreement' (the expression used is in fact 'pre-existing heads of agreement' (see paras 17 and 20)) and when an asset is 'under construction' (para 24). It is clear that heads of agreement which are too vague (e.g. as to the description of the relevant asset or the identity of the lessee) will be insufficient for this purpose and it is specifically required that the lessee under the lease must be the particular person identified as such in the heads of agreement. Also, the principal terms of the lease must not be materially different from those in the heads of agreement.

As far as 'construction' is concerned, it is provided that an asset may be treated as under construction at any time after the start of construction of one of its component parts provided that the relevant component part has been identified as a component part of the asset in question before construction of that component begins. In practice, it may not always be easy to demonstrate that a component has, at such an early stage, been designated for use in a particular asset, so that this rule may give rise to some practical difficulties.

(c) Again subject to the grandfathering rule in (a) above, the FA 2006 regime *will* apply where the commencement of the term of the lease was before 1 April 2006 but the relevant asset is brought into use for the purposes of a trade (or other qualifying activity) within the UK tax net on or after that date. This rule appears to be directed at non-residents who entered into leases that commenced before 1 April 2006 but who come within the UK tax net (e.g. by becoming resident in the UK) only subsequently. The clear intention is that such leases should be subject to the FA 2006 regime (except where the relevant lease was finalised before 21 July 2005 and the lessor was within the charge to UK tax on 17 May 2006).

(d) It follows that the FA 2006 regime will *not* apply where – even though the relevant lease was not finalised before 21 July 2005 (so that there can be no grandfathering pursuant to the rule in (a) above) – the lease was finalised before 1 April 2006, the commencement of the lease term was before that date and, in addition, the equipment was brought into use before that date for the purposes of an activity within the UK tax net (so that the rule in (c) above does not apply).

(e) By virtue of para 21, some partial grandfathering is provided where heads of agreement were in place before 21 July 2005 but the lease itself does not fall to be grandfathered pursuant to the exception described in (b) above. In this scenario, expenditure incurred on the provision of the relevant plant or machinery before 19 July 2006 (the date of enactment of FA 2006) will be treated as if it had been incurred on the provision of a separate asset for leasing under a separate long funding lease and as if the exception described in (b) applied. The result seems to be that – assuming that the actual lease was finalised, or the lease term commenced, on or after 1 April 2006 – such expenditure will be grandfathered (and thus qualify for allowances in the lessor's

hands) but the rentals under the actual lease must then be apportioned on a just and reasonable basis, so that a proportionate part of the lease income is taxed under the old regime. Detailed rules are set out in para 22 for determining the date on which an amount of expenditure is to be treated as incurred for these purposes. These include a provision designed to render ineffective any attempt to accelerate this date by varying the terms of a relevant agreement. The general rule is that an amount of expenditure is treated as incurred as soon as there is an unconditional obligation to pay such amount.

Thus, in broad terms, it follows from paragraphs (a) and (d) above that there is complete grandfathering for most leases finalised before 21 July 2005 and that most leases finalised on or after that date but before 1 April 2006 will be grandfathered provided that the leased asset is made available to the lessee before 1 April 2006.

11. Summary

In summary, therefore, the general position is that a lease of new equipment will fall within the ambit of the FA 2006 regime if it is a funding lease (i.e. in general, but not necessarily, a finance lease for accounting purposes), which is not a short lease or a lease of a qualifying ship to a tonnage tax company and which is not grandfathered under the transitional rules. The new regime will not apply to plant or machinery leased as an incidental part of a typical property lease.

Where the FA 2006 regime does not apply, the old system under which capital allowances are available to lessors of plant or machinery (including finance lessors) will continue to apply, albeit with certain modifications specified in FA 2006, Sch 9. This is discussed in much more detail from 13 below. Where the lease in question is a long funding lease subject to the FA 2006 regime, expenditure incurred by the lessor on the provision of the relevant plant or machinery will not qualify for capital allowances and the position will be as described in 12 below.

12. LEASES SUBJECT TO THE FA 2006 REGIME (LONG FUNDING LEASES)

A detailed description of the tax treatment of long funding leases which are not grandfathered under the transitional rules and are therefore subject to the new regime is beyond the scope of this article. As already explained, a lessor which incurs expenditure on plant or machinery for leasing under such a lease will not be entitled to capital allowances and so will not itself be entering into a tax-based leasing arrangement with the financial implications described in 2 above. It is true that there may be some scenarios in which leasing activity will continue in the future even though the lessor cannot claim allowances. For example, operating leasing will still have the attraction for potential lessees of being 'off balance sheet' as an accounting matter. A company looking to finance an investment in equipment might therefore be interested in entering into a funding lease (within the scope of the new regime) which may be accounted for as an operating lease, in preference to simply borrowing the money and purchasing the asset itself. However, this is an accounting issue. The lessor will not be providing any tax attributes, such as the ability to claim allowances and the tax capacity to absorb them.

In brief, however, it is provided by CAA 2001, s 70A that where a lease of plant or machinery is subject to the FA 2006 regime, the lessee will become entitled to capital allowances, assuming that its expenditure under the long funding lease is incurred for the purposes of its trade (or other qualifying activity – as to which, see CAA 2001, s 15). The computation of the precise amount qualifying for allowances will depend on whether the lease is a finance lease or an operating lease: see ss 70B and 70C. In broad terms, the position in the case of a finance lease is that the amount qualifying for allowances will be an amount equal to the present value (generally determined at the commencement of the lease term) of the 'minimum lease payments' (explained in 6 above). Where the lease is an operating lease, the amount qualifying for allowances will be equal to the market value of the equipment, again generally determined at the commencement of the lease term.

However, by virtue of CAA 2001, s 70DA, the lessee's position is modified in the case of a sale (or lease) and lease-back of the equipment, where the lease-back is either to the original owner or to a connected person and is a long funding lease. In these circumstances, the amount qualifying for allowances in the hands of the lessee (under the lease-back) is restricted to the disposal value required to be brought into account by the seller (or the head lessor) (see, generally 20 below). Where no such disposal value has to be brought into account, the restriction operates by reference to the lower of the market value of the equipment and any capital expenditure incurred on the provision of the equipment by the original owner. The broad effect, in either case, is to limit the sum qualifying for allowances to the original cost of the equipment and to prevent an uplift in this sum being obtained by means of a sale (or lease) and long funding lease-back of equipment which has become worth more than its original cost. Moreover, a similar new rule is introduced by CAA 2001, s 229A in order to produce a corresponding result where, instead of a long funding lease-back, there is a hire purchase (or similar) contract with the original owner (hire purchase contracts are discussed generally in 18 below). These modifications have been introduced by FA 2009, Sch 32 and apply where the commencement of the term of the long funding lease-back (or, as the case may be, the date of the hire purchase contract) is on or after 13 November 2008.

It is worth emphasising that the question of whether a lease is a long funding lease has to be addressed independently by lessors and lessees. Theoretically, therefore, a lease may be a long funding lease in the hands of the lessee but not in the hands of the lessor. It is therefore specifically provided by s 70Q that a lessee will not be entitled to capital allowances where the lessor, or any superior lessor, is entitled to claim allowances (which need not be plant or machinery allowances) in respect of the leased asset or would have been so entitled if it had been within the charge to UK tax. This latter point will have to be watched in the case of a leasing arrangement which is intended to provide both overseas tax depreciation to a non-UK lessor and UK capital allowances to the UK resident lessee.

It clearly follows from the structure of the FA 2006 regime that, where there is a chain of long funding leases, the entitlement to plant or machinery allowances will in principle fall to the long funding lessee at the 'bottom' of the chain. Thus, where a head-lease and sub-lease of a particular asset are both long funding leases (in the hands of each relevant party), CAA 2001, s 34A will deny allowances to the head-lessee (see 5 above) and the entitlement will fall to the sub-lessee.

One further point to note in relation to capital allowances is that an owner of plant or machinery who enters into a long funding lease will (not surprisingly) be required to bring disposal value into account: see CAA 2001, s 61 and, more generally, see 20 below. Under item 5A of the table in CAA 2001, s 61(2) (as amended by FA 2009), the disposal value in circumstances where the lease is a finance lease will be an amount equal to the greater of:

(a) the market value of the equipment at the commencement of the lease term; and

(b) the minimum payments under the lease (including any initial payment but excluding the 'finance charge' element of the rentals).

However, where inception of the lease was prior to 13 November 2008, the disposal value is an amount equal to the lessor's net investment in the lease on the date on which this is first recognised in the lessor's books.

Where an equipment lessee is entitled to allowances, the corporation tax rules are amended to ensure that the lessor will be taxable only on the finance charge element of the rental payments and that the lessee can obtain only a corresponding amount of tax relief.

Where the relevant lease is accounted for as a finance lease, the treatment is quite straightforward. The lessor is taxed on its rental earnings for the relevant period – i.e. the amount which, in accordance with generally accepted

accounting practice, falls to be treated as the gross return on investment for the period in respect of the lease (CTA 2010, s 360). In the light of this limitation upon the portion of rental payments that are taxable, it is not surprising that the general rule is that rental rebates paid to the lessee on termination of the lease are not deductible in the lessor's hands. As far as the lessee is concerned, it is provided by CTA 2010, s 377 that tax relief in respect of lease payments is limited to the amounts shown in its accounts as finance charges in respect of the relevant lease.

The position is inevitably more complex where the lease in question is accounted for as an operating lease, because the relevant numbers will not be readily available from the accounts. Accordingly, detailed rules are inserted into the legislation to achieve broadly the same result as in the case of finance leases. In essence, the position for lessors – in the case of a new asset – is that the difference between the cost of the asset and its expected residual value (calculated at the commencement of the lease term) is deductible over the lease term on a straight line basis. The annual deduction (which is obviously akin to depreciation) can then in effect be set against the gross rentals, the difference constituting the taxable finance charge for the relevant period. This annual deduction for the lessor is matched by a broadly comparable reduction in the amount of tax relief available to the lessee in respect of its rental payments (CTA 2010, s 379).

It appears that there may have been some exploitation by certain lessors of these rules restricting their taxable income to the finance charge element of the rental payments. In the 2007 Pre-Budget Report, HMRC indicated that they were aware of cases where a lessor was likely to contend that it had acquired plant or machinery on trading account – entitling it to claim tax relief for the entire cost as a revenue deduction – and leased the equipment out under a long funding lease so that its taxable income would be restricted by virtue of CTA 2010, ss 360-369 (the amended corporation tax rules applicable to lessors). Accordingly, anti-avoidance rules were enacted in 2008 and are now set out in CTA 2010, ss 370-375.

In very broad terms, the rules in CTA 2010, ss 360-369 will be disapplied in two scenarios:

(1) The first is where any part of the expenditure incurred by the lessor on the acquisition of the equipment is allowable as a deduction in computing its profits or losses for corporation tax purposes and is so allowable as a result of the equipment forming part of its trading stock (thus addressing, it would seem, the specific 'scheme' referred to above): see CTA 2010, s 370.

(2) The second, and rather broader, scenario is where the main purpose, or one of the main purposes, of the overall arrangements (of which the long funding lease forms part) is to secure that there is a substantial difference between the profits attributable to those arrangements recognised in the lessor's accounts and the amounts brought into account for tax purposes (the difference being due in whole or in part to the application of any of CTA 2010, ss 360-369): see CTA 2010, s 373.

    In the 2007 Pre-Budget Report, HMRC merely stated that their intention, in this latter case, is to counter arrangements entered into with a view to exploiting the long funding lease rules in order to generate tax losses in circumstances where there are no or minimal commercial losses. This latter change applies to arrangements entered into on or after 9 October 2007.

In addition to the above, it is provided by CTA 2010, s 376 that ss 360-369 will also be disapplied where a film is leased under a long funding lease. In the absence of this modification, it would be possible for the rental stream under such a lease to go largely untaxed in circumstances where the lessor might nevertheless have been able to claim tax relief for the cost of the leased film on revenue account.

An important point to note in relation to lessees is that (subject to what is said below) a lessee is not compelled to treat any lease as a long funding lease. By virtue of CAA 2001, s 70H, a lease will not be a long funding lease in the case of a lessee unless the lessee treats it as such in its tax return. The effect is that the lessee may, if it wishes, obtain tax relief for its gross rental payments in accordance with the traditional (pre-FA 2006) rules, albeit that neither party to the lease with then be entitled to capital allowances. The traditional rules governing rental deductions for lessees are described in 33 below.

In the case of a sale (or lease) and long funding lease-back, this element of choice is not open to the relevant lessee. The lease-back must be treated as a long funding lease and tax relief will *not* be available for the gross rental payments on the traditional basis: see s 70H(1C).

Subsequent to the 2007 Pre-Budget Report, HMRC became aware of further 'tax planning' involving chains of leases and the rules in CTA 2010, ss 360-369 and (in some instances) CAA 2001, s 70H as well. It appears that a number of 'schemes' were disclosed to HMRC pursuant to the FA 2004 disclosure regime, referred to at 40 below. Typically, these seem to have involved a lease of equipment from the owner to an intermediate lessor, which in turn sub-leased the asset to a sub-lessee.

From the perspective of the intermediate lessor, the head lease would be structured as a lease that was not a long funding lease (this might be on the basis that the intermediate lessor simply decided to treat it as not being a long funding lease pursuant to s 70H), but the sub-lease – having broadly the same terms – would be structured as a long funding lease. The intention would have been to ensure that under the head lease (not a long funding lease), the intermediate lessor would be entitled to tax relief for the entirety of the rentals payable by it, while it would be taxable under the sub-lease (the long funding lease) only on the finance charge element of the rentals receivable from the sub-lessee. In order to remove this unintended benefit, it is now provided by CTA 2010, s 372 that in these circumstances ss 360-369 will not apply in relation to the sub-lease, the effect being that the intermediate lessor will be taxable on the sub-lease rentals in full. This new provision applies where the sub-lease is entered into on or after 13 December 2007. Where the relevant sub-lease (the long funding lease) was in place at the beginning of 13 December 2007 and was a finance lease, the sub-lease rentals will be taxed in full in the hands of the intermediate lessor, insofar as those rentals are due on or after that date and are referable to periods after 12 December 2007.

Finally, CAA 2001, s 70H is amended by FA 2008, Sch 20, para 8 so that it does not apply where the lessee in question is also the lessor of the relevant plant or machinery under a long funding lease. In this situation, the intermediate lessor (i.e. the lessee under the head lease) will have to treat the head lease as a long funding lease (where that lease is a long funding lease as a matter of principle) and it will therefore not be entitled to tax relief for the entirety of the rentals payable.

13. TRADITIONAL EQUIPMENT LEASING – LEASES OUTSIDE THE AMBIT OF THE FA 2006 REGIME

An equipment lease will not be subject to the FA 2006 regime (as described above) if it is not a long funding lease or it is grandfathered under the transitional rules: see 5–11 above. The most important examples of this are: operating leases which are not treated as funding leases, short leases, leases of qualifying ships to tonnage tax companies and grandfathered leases.

Where the FA 2006 regime does not apply, the equipment lessor's objective, as in the past, will be to obtain capital allowances in respect of its expenditure on the leased asset. The old (pre-FA 2006) regime will apply for the purpose of determining the lessor's entitlement to allowances and will, as a general matter, govern the tax treatment of the leasing transaction. However, this is subject to some important modifications to the detail of the

old rules that have been introduced by FA 2006, Sch 9. The commencement rules vary to some extent between different modifications but, in broad terms, the remainder of this article reflects the modified old regime.

14. TRADITIONAL EQUIPMENT LEASING – THE LESSOR'S ENTITLEMENT TO CAPITAL ALLOWANCES

The most important question asked in relation to any traditional leasing deal (not subject to the FA 2006 regime) is whether allowances will be available to the lessor, on what and at what rate. This aspect of the finance leasing business is so fundamental that it will be considered first.

In order to claim writing-down allowances on plant or machinery pursuant to CAA 2001, s 11, three conditions must be satisfied:

(i) capital expenditure must be incurred on the provision of plant or machinery;

(ii) the provision of that plant or machinery must be for the purposes of a trade (the profits of which must be within the charge to UK tax); and

(iii) the person incurring the expenditure must own the plant or machinery as a result of incurring it.

These conditions – each of which raises separate questions for consideration – are slightly amended if the claim is made under CAA 2001, s 67 (hire purchase or conditional sale deals). In particular, s 67 may make it unnecessary for the plant or machinery to be owned. Furthermore, allowances may be available to a lessor even if there is no underlying trade (see CAA 2001, s 15(1)(h) and s 19). These issues are discussed further below.

15. Capital expenditure etc.

Little difficulty will usually be experienced on a straightforward purchase of an asset to be leased in demonstrating that the expenditure being incurred is capital and not revenue in nature. In some cases, even such items as legal fees and registration fees may qualify but, since the abolition of 'across the board' 100% first-year allowances, it has generally been better if relief for these can be claimed so far as possible as a trading expense. Problems can, however, arise with certain peripheral expenses (e.g. surveyors' costs when fixed plant or machinery is being installed) and/or with certain fringe items such as film rights and computer software.

The expenditure must also be on 'the provision' of the asset itself, not extraneous rights such as a valuable rental stream or some other benefit. This has always been a particularly difficult point on sale/leaseback deals with existing plant. It is notoriously difficult to value secondhand plant and sometimes impossible to separate its value from the price a lessor is prepared to pay in the knowledge that a finance lease will immediately be entered into with a credit-worthy lessee. Since such a lease will enable the lessor to recoup whatever investment it makes in full, the price paid for the asset becomes almost irrelevant. There is, however, a danger that a price which exceeds the value of the asset unsupported by the lease will be partially disallowed for capital allowance purposes.

These difficulties are illustrated to some extent by the decision of the High Court in *Barclays Mercantile Business Finance Ltd v Mawson [2002] STC 1068*, which was subsequently reversed on appeal. In deciding that the lessor's expenditure was not incurred on the provision of the pipeline (albeit by virtue of an awkward application of the *Ramsay* doctrine), Park J appears to have considered it significant that no attempt had been made to determine the open market value of the asset, although there was no evidence whatsoever to suggest that the pipeline was worth less than the price paid by the lessor – on the contrary, the asset had only just been constructed, and at a cost which appears to have been greater than the sale price to the lessor.

Expenditure incurred before a trade commences is treated as having been incurred when the trade commences (CAA 2001, s 12). This is relevant to someone setting out in the leasing business and not yet in receipt of rental income.

The rule used to be that expenditure was treated as incurred when 'payable', but more recently the date on which expenditure is treated as incurred for capital allowance purposes has been brought into line with the date on which it is treated as incurred for normal accounting purposes. Under CAA 2001, s 5, an amount of capital expenditure is treated as being incurred as soon as there is an unconditional obligation to pay it. This will usually (but not always) be the date when title passes to the purchaser of the asset. Where, however, the purchaser acquires title at an earlier date (for example where an asset is built to order and title passes as construction proceeds), then so long as an unconditional obligation to pay the price comes into being (typically on the issue of an engineer's or architect's certificate) within one month of the end of the accounting period in which title passed, the expenditure will be treated as incurred in the period in which title passed. Section 5 does not apply to accelerate expenditure which, although the obligation to incur the same has become unconditional, is not actually payable until more than four months after the date of the relevant contract. It is intended, therefore, only to achieve a relatively marginal acceleration of expenditure incurred at or around accounting year ends. As may be expected section 5 also contains provisions designed to prevent expenditure from being accelerated artificially. Contractual terms for payment must not be distorted so as not to accord with normal commercial usage.

Expenditure will not be treated as having been incurred if it is covered by government subsidies or by a contribution from a third party (see CAA 2001, ss 532 to 538). Great care should also be taken with some of the more exotic security deposit or non-recourse or other lessor financing schemes to ensure that it can be said that, at the end of the day, the relevant expenditure has genuinely been incurred by the lessor – a point which was reinforced by the decision of the House of Lords in *Ensign Tankers (Leasing) Ltd v Stokes 64 TC 617* (although now see *Tower MCashback LLP1 v Revenue and Customs Comrs [2010] STC 809*).

16. Plant or machinery

Although there is no general definition of the terms plant and machinery in the legislation – except to include interests in assets or parts of assets (CAA 2001, ss 270 and 571) – the courts have given a wide interpretation to their meaning. The reader should refer to a general text book for a detailed discussion of these terms and of the relevant case law.

The most significant legislative intervention in this area has been in the context of buildings and structures. The effect of CAA 2001, ss 21–24 is that expenditure on the provision of a building – including any asset incorporated into a building or of a kind 'normally' incorporated into buildings – or on certain structures will not qualify for plant and machinery allowances. It is understood that the introduction of this statutory rule in 1994 was provoked by an increasing number of decisions of the Commissioners in which such assets or structures were being held to constitute plant. However, the legislation does attempt to preserve the effect of earlier decisions of the Courts (but not the Commissioners) by setting out lists of assets or items of expenditure which have, in the past, been held to qualify for plant and machinery allowances and which are therefore to be exempt from the effect of these statutory provisions (e.g. cold stores and dry docks). An important point to note is that these exempt items will still need to qualify as plant or machinery pursuant to the case law rules, under which the particular use to which the asset is put (and not just the nature of that asset) will be relevant: see, for example, *Shove (Inspector of Taxes) v Lingfield Park 1991 Ltd [2004] EWCA Civ 391, [2004] STC 805*.

More recently, HMRC have again focused on this area in the context of the general capital allowance reforms first announced in the 2007 Budget. Their main concern appears to have been that equipment such as lifts and central

heating is merely integral to any modern building, and so should not qualify for allowances at the full standard rate (now 20% per annum: see 20 below) which does not generally reflect their average rate of economic depreciation.

Accordingly, FA 2008, s 73 has introduced a new classification of features that are integral to a building ('integral features'). Expenditure on these assets (which are listed in the legislation) will qualify for allowances – irrespective of whether they would constitute plant or machinery under general principles – but only at the current rate of 10% per annum, and such expenditure will be included in a new 10% pool (see 20 and 22 below). The expenditure in question is defined in the new CAA 2001, s 33A. It is expenditure incurred on the provision or replacement of an integral feature of a building or structure used for the purposes of a trade (or other qualifying activity: see 17 below). The term 'integral feature' is narrowly defined and includes lifts and escalators, heating systems and electrical and lighting systems. Such expenditure is effectively deemed to be capital expenditure on the provision of plant or machinery and where it is incurred on or after 1 April 2008, it is treated as 'special rate expenditure' for the purpose of CAA 2001, s 104A and is therefore eligible for allowances at the 10% rate (pursuant to s 104D) and must be allocated to the new 10% pool: see FA 2008, Sch 26.

Another point to note is that computer software (and the right to use it) may be treated as plant (CAA 2001, s 71). Although the Finance Act 2002 introduced a completely new corporation tax regime for intangible assets – tax relief for the cost of such assets generally being given at the rate at which those assets are depreciated in the taxpayer's accounts and capital allowances no longer being available – lessors (and others) may elect to preserve the existing entitlement to capital allowances in respect of capital expenditure on computer software (CTA 2009, s 815). Such an election must be made within two years from the end of the accounting period in which the expenditure was incurred. When no such election is made, the new regime will apply. In this event, the tax treatment of a finance lessor will be governed by regulations made pursuant to CTA 2009, s 854. The purpose of these regulations is apparently to provide finance lessors with an entitlement to tax relief on revenue account (and on an accounting basis) for the cost of acquiring intangible assets, even though the leased assets themselves will not appear in their accounts. In general, however, capital allowances treatment (if available) would appear to be preferable because of the tax deferral benefits referred to above.

17. For the purposes of a trade

The requirement that the equipment must be provided 'for the purposes of the trade' carried on by the person incurring the expenditure will rarely cause difficulty for any leasing company. Moreover, the effect of CAA 2001, s 15 (which lists the full range of 'qualifying activities' for the purposes of plant and machinery allowances) and CAA 2001, s 19 is that the leasing of plant or machinery otherwise than in the course of an actual trade is to be treated as a 'qualifying activity' (in essence, as a deemed trade) for these purposes. Such leasing, which was formerly governed by CAA 1990, s 61, is now described in the legislation as 'special leasing'. In effect, therefore, the trading requirement will always be satisfied in the case of assets that are to be leased.

HMRC accept that leasing as carried on by the usual financial lessor is a trade for tax purposes and it is important for several reasons for lessors to establish a leasing trade. For example, if the lessor does not carry on an actual leasing trade, the effect of section 19 is that expenditure is treated as having been incurred only at the commencement of the letting. Therefore, a lessor will not be able to claim allowances on expenditure incurred prior to the commencement of the lease period until that date and this may be a severe disadvantage with a long purchasing or construction programme. The other main reason for having a trade is to ensure that allowances can be set off against the lessor's general income. If the allowances are given under the 'special leasing' regime, this will not be possible where the asset is not used for a trade carried on by the lessee (see CAA 2001, ss 259 and 260 and see also the case of *Gold Fields Mining and Industrial Ltd v GKN (UK) plc [1996] STC 173*). In the past, this problem was solved by using a separate leasing subsidiary and group-relieving surplus allowances against the total profits of other group companies. As a result of a change made to the group relief rules by the Finance Act 1989

(now incorporated in CAA 2001, s 260(7)), this is no longer possible. It is, therefore, even more important now to establish a leasing trade. Having a trade will also permit a short-life asset claim to be made (where appropriate) and enable the lessor to take advantage of the accruals basis of taxation of rental income. The latter is particularly useful when a deal is entered into late in an accounting period, given that it is usual for rentals to be paid in advance. An accruals basis of taxation enables recognition of rental income to be substantially deferred until the next period.

Although there should be no difficulty in practice in establishing a leasing trade for tax purposes, it is not possible to say with certainty how many leases must be entered into before HMRC will accept that a trade exists. There are also said to have been various unreported Special Commissioners' decisions supporting HMRC contentions that leasing companies outside the financial sector were not trading. These decisions appear to have involved rather special facts. Given its essentially financial nature, the line between investment and trade for a financial leasing activity is a fine one. On past experience a series of leasing transactions displaying a pattern of activity will establish a trade for tax purposes, and it is usually said that a lessor should enter into at least three separate transactions in order to establish a leasing trade and that some rental income should have been received. A lessor embarking on leasing for the first time should obviously avoid any exotic financing structures or transactions. A spread of business over an extended period with the maximum possible involvement by the lessor is helpful. A simple way of demonstrating involvement by the lessor is, for instance, for the lessor to undertake the relatively straightforward work involved in the invoicing and collecting of rentals rather than having it handled by a manager but this is not absolutely necessary. Volume of transactions is much the most important single factor.

18. Ownership

A lessor will be able to obtain allowances in respect of expenditure incurred on the acquisition of machinery or plant if he owns (or has owned) the asset as a result of incurring that expenditure (CAA 2001, s 11(4)(b)).

Under long-standing HMRC practice, instalments or stage payments (e.g. on ships being constructed) were eligible for first-year allowances when paid even though title might not pass immediately. This practice has been extended to claims for writing-down allowances.

CAA 2001, s 67 deems an asset to be owned by the claimant once *capital* expenditure has been incurred under a contract which provides that title to the asset will or may pass at some future time. This avoids problems which would otherwise arise with title and payment retention clauses as well as providing relief for hire purchase and conditional sale arrangements (in advance of title to the asset passing).

However, where the contract is finalised on or after 1 April 2006 and falls to be treated as a lease in accordance with generally accepted accounting practice (in other words, it is a hire purchase contract rather than a sale contract), the asset will be treated as owned by the claimant (the lessee) only if the lease is a finance lease for accounting purposes (CAA 2001, s 67(2B)). Moreover, where the lessee is not to be treated as owner of the asset merely because of this new rule (i.e. because the contract is accounted for as an operating lease), it is provided that no other person (e.g. the legal owner) may be treated as owning that asset for capital allowance purposes.

The requirement that the hire purchase contract must be accounted for as a finance lease has been presented as an anti-avoidance measure. In their explanatory notes on the provision, HMRC state that a conventional hire purchase arrangement, involving an option to acquire the asset at the end of the lease term for a nominal sum, will indeed be a finance lease for accounting purposes, so that the asset may be treated as owned by the hirer/lessee; while conventional operating leases will be unaffected because (by implication) even if there is an option to purchase the asset, the option will be exercised at (broadly) fair value, so that s 67 will be wholly inapplicable (no initial capital expenditure being incurred under the lease) and the legal owner will be entitled to allowances pending exercise

of the option. It seems, therefore, that the probable target of this legislative change is an arrangement where the periodic payments under the contract do not genuinely comprise any capital expenditure but, rather, a (possibly nominal) capital sum is required to be paid at the start of the lease just to trigger the application of s 67 (as it stood prior to this change in the law). However, it must be said that the 'abuse' in question has been poorly explained and there must be some concern that the drafting is broad enough to catch perfectly innocent arrangements.

Where a person who is in principle entitled to be treated as owning an asset pursuant to s 67 intends to lease that asset on to an end user, that person's entitlement to allowances will depend on whether or not such lease (to the end user) is a long funding lease within the meaning of the FA 2006 reforms (i.e. under the new Chapter 6A). If it is a long funding lease, allowances will be denied to the lessor under CAA 2001, s 34A. If the lease to the end user is not a long funding lease, the lessor will in principle be entitled to capital allowances, but where the lease is nonetheless a finance lease (see s 219), s 67(3) will not be applicable to the contract (e.g. hire purchase contract) pursuant to which the lessor has acquired tax ownership of the relevant asset (see s 229(3)). This will mean that it will not be possible for the lessor to accelerate all future capital expenditure under the s 67 contract to the date on which the equipment was brought into use. However, this limitation will not apply where the lease to the end user is an operating lease.

Where such acceleration of future capital expenditure is sought (e.g. in the case of an asset leased under an operating lease), it is important to appreciate that it will not be available where the relevant asset is being acquired pursuant to a *credit* sale arrangement (in contrast to a hire purchase or conditional sale). Problems can arise with certain supplier credit arrangements where title passes immediately but payment is deferred on agreed terms. If possible, the passing of title should also be deferred so that these arrangements fall within section 67. It should also be noted that section 67 only applies once capital expenditure has been incurred. In practice, this condition is treated as satisfied with short-term hire purchase or conditional sale agreements once the first rent or other instalment has been paid. With long-term (i.e. five year and over) hire purchase and conditional sale agreements, especially ones where the expenditure is rear-end loaded, problems may arise in differentiating between payment for the use of the asset pending the passing of title (which will constitute revenue expenditure deductible as and when incurred) and payment for the right to acquire title (see *Darngavil Coal Co Ltd v Francis 7 TC 1*).

19. Ownership and fixtures

The ownership requirement was – prior to the enactment of CAA 2001 – framed as a requirement that the asset must 'belong' to the claimant. This requirement caused particular difficulties in the context of equipment which constituted fixtures for the purposes of property law. In *Stokes v Costain Property Investments Ltd 57 TC 688*, the Court of Appeal held that lifts and central heating equipment which, on installation in two buildings, became part of the landlord's fixtures could not be said to belong to a tenant company which had incurred the expenditure on the relevant equipment. The word 'belong' was not satisfied by any lesser interest than absolute ownership. In that sense it was akin to beneficial ownership which has a recognised tax meaning.

It was rumoured at the time that the Inland Revenue did not wish to win the *Costain* case on the grounds they did. Accordingly it was not surprising when provisions overriding the main effect of the case were included in FA 1985, now CAA 2001, Pt 2 Ch 14. So far as equipment lessors are concerned, this statutory regime has not only cleared up a past difficulty as between freeholders and lease holders (the main point at issue in *Stokes v Costain*); it has generally enabled them to lease fixtures on a deemed ownership basis without taking any interest in the underlying land. For property development, the results have also been wholly beneficial. Capital allowances on air conditioning, lifts and general fitting out items have been readily available to the person who incurred the relevant expenditure regardless of the property interest held (although it should be noted that many items of equipment fixed within a building will not constitute machinery or plant, as a result of CAA 2001, ss 21 to 24, discussed at 16 above).

The provisions in Chapter 14 must be applied in order to determine who is entitled to capital allowances for machinery or plant which constitutes a fixture. The term ‘fixture’ means any machinery or plant which is so installed or otherwise fixed in or to a building or any other description of land as to become, in law, part of that building or other land (CAA 2001, s 173). Thus it includes both landlords’ fixtures and tenants’ fixtures.

The basic approach of these provisions is to deem the machinery or plant to be owned by one person (and one person alone) who has an interest in the land to which it is fixed. The main rule is set out in CAA 2001, s 176: if a person incurs capital expenditure on the provision of machinery or plant (for the purposes of a trade carried on by him), the machinery or plant becomes a fixture and at that time the person has an interest in the relevant land, then that person is deemed to be the owner of the machinery or plant in question. If two or more people have incurred capital expenditure on the machinery or plant and have different interests in the land, the owner will, it would appear, be deemed to be the person with the inferior interest. Given that the incurring of expenditure (which can hardly happen by accident) is an essential prerequisite, this seems entirely sensible and the fact that an interest in land includes not only leases and licences (as to the latter, see Tax Bulletin June 2000 p 761) but also easements (and any agreement to acquire one) serves to help all incurring expenditure on fixed plant or machinery (including cable or pipeline owners).

Further provisions are included to deal with changes in ownership of the interest of the person by whom the machinery or plant is deemed to be owned and grants of interest out of such interest (see CAA 2001, ss 181 to 184). If the person who is treated as the owner of a fixture by virtue of any of these rules ceases to have the qualifying interest in the land (which in the case of the grant of a lease is the lease itself), he is then deemed to cease to own that fixture. It will be treated as sold by him at a price to be determined in accordance with detailed provisions set out in CAA 2001, ss 196 to 201.

As mentioned above, the legislation makes special provision for equipment lessors. The effect of CAA 2001, ss 177 and 178 is that an equipment lessor may become entitled to be treated as the owner of a fixture, even though he has no interest in the relevant land. The relevant provisions apply where the equipment lessor incurs capital expenditure on the provision of machinery or plant for leasing and the machinery or plant becomes a fixture. If an agreement is entered into for the lease of the machinery or plant, otherwise than as part of the relevant land, to another person (‘the equipment lessee’) for the purposes of a trade (or other qualifying activity) carried on by the equipment lessee, and if the equipment lessee would have been entitled to allowances by virtue of the main rule contained in section 176 had he incurred the relevant expenditure, then the equipment lessor and the equipment lessee may elect that the fixture be treated as owned by the equipment lessor. The agreement for the lease may be entered into before the lessee has started to trade (in which case allowances will be granted from the time when the lessee begins to trade) (CAA 2001, s 177(3)). It is HMRC’s view that the equipment lease need not, as a general rule, be concluded before the machinery or plant becomes a fixture (see Tax Bulletin October 1994, page 166). The election must be made within two years of the end of the chargeable period in which the capital expenditure was incurred. However, no election may be made if the equipment lessor and the equipment lessee are connected persons.

In the light of modifications to these rules introduced in 1997, it is clear that a ‘no land interest’ or deemed lease may be entered into only with a lessee who is within the charge to UK tax and would have been entitled to claim allowances pursuant to the ‘fixtures’ regime if he had himself incurred the capital expenditure. It follows that the lessee may not, for example, be an exempt body such as a local authority or a charity. In this respect, the effect of the decision of the House of Lords in *Melluish v BMI (No 3) Ltd 68 TC 1* has been reversed. However, there is a limited exception to this rule in the case of severable equipment which is fixed to land other than a building and is leased under an operating lease (see CAA 2001, s 179).

An issue which appears to have caused some confusion in the past is the precise inter-relationship between the 'fixtures' regime and CAA 2001, s 67 (hire purchase and conditional sale arrangements). The concern seems to have been that there might be circumstances in which an item of fixed plant or machinery deemed to be owned by one person under the 'fixtures' code could be deemed to be owned by a different person under section 67. This appears somewhat at odds with the view of the House of Lords in the *BMI* case that what is now Chapter 14 provides an exhaustive code for identifying the owner of an item of fixed equipment for capital allowance purposes. Nonetheless, any area of possible conflict has been resolved by the introduction of what is now CAA 2001, s 69. Not surprisingly, this provides that the 'fixtures' code will prevail in these circumstances and that section 67 does not apply to expenditure incurred on fixtures. Where an asset which has been treated as owned by a person pursuant to section 67 becomes a fixture, it will then be treated as ceasing to be owned by that person (except where it is in fact deemed to be owned by him under the 'fixtures' code).

Another point relevant to fixtures leasing is that the rental income ought technically to be brought into charge under CTA 2009, Part 4 in the computation of the profits of a property business. If the point were technically taken – which, in practice, it is generally not – this would affect the lessor's ability to carry forward losses against such income (unlikely to be relevant for most leasing companies).

The VAT and stamp duty land tax aspects of fixtures leasing are discussed at 36 and 37 below.

Not surprisingly, it is made clear in CAA 2001, s 172A that where a fixture is the subject of a long funding lease (within the meaning of the new Chapter 6A, inserted by FA 2006), the FA 2006 regime will prevail and the longstanding fixtures code will not apply to determine ownership of the relevant asset or entitlement to allowances. This will be the case even where the lessee sub-leases the fixture under a lease which is not itself a long funding lease.

20. WRITING-DOWN ALLOWANCES – THE POOL SYSTEM

The general rate of writing-down allowance on plant and machinery expenditure was reduced from 25% to 20% with effect from 2008/09 (except where the asset is used in a ring-fence trade). In the case of companies, the 20% rate applied from 1 April 2008. This gave rise to a 'hybrid' rate for any chargeable period straddling 1 April 2008. Thus, where a company has a year end of 31 December 2008, approximately 25% of the period falls before the rate change (the precise portion depends on the number of days falling before the date of the rate change), so that the 'hybrid' rate of allowance for the full 12-month period will be roughly 25% of the old 25% rate, being 6.25%, plus roughly 75% of the new 20% rate, being 15%, resulting in a rate of allowance of approximately 21.25% for the whole period. This 'hybrid' rate of 21.25% is provided for by FA 2008, s 80(9)(10). In the example just given, it is immaterial whether qualifying expenditure incurred in the straddling period was incurred before 1 April 2008 or on or after that date.

It has been announced in the June 2010 Budget that this general rate of allowance will be reduced to 18% in respect of chargeable periods of companies ending on or after 1 April 2012.

The most important point to note about writing-down allowances is that they are calculated by reference to the reducing balance of the original expenditure. Thus if expenditure of £10,000 is incurred at the beginning of a year, the first year's allowance (at the current rate of 20%) will be £2,000, the next year's will be 20% of £8,000 and so on. In theory, this means that the original cost may never be fully written off. Where an accounting period is less than 12 months in length or the leasing trade is carried on for part only of an accounting period, the percentage allowance is scaled down proportionately: see CAA 2001, s 56.

Until the July 1997 Budget it did not matter at what point in the accounting period the initial capital expenditure was incurred – whether it was incurred on the first day or the last day of the period, the entire expenditure would (subject to the rules mentioned in the preceding paragraph) qualify for a writing-down allowance in respect of that period. However, this has ceased to be the case where the expenditure is incurred for the purpose of leasing under a finance lease (as defined in CAA 2001, s 219). Instead, by virtue of CAA 2001, s 220, the eligible expenditure in the first year will be limited on a time apportionment basis by reference to the proportion of the accounting period which remains after (i.e. starting with) the time when the expenditure was incurred. So if a finance lessor with a 31 December year end incurs expenditure of 100 on 1 October, the portion of that expenditure qualifying for allowances in respect of the year in which the expenditure is incurred will be one-quarter only, i.e. 25. The balance of 75 will then be added to his eligible expenditure for the subsequent accounting period. The overall effect is, therefore, that allowances will in principle remain available on the total cost of the asset, but the rate at which that cost is written down will be reduced.

This was obviously a fundamental change for the finance leasing industry (especially when taken together with the changes to the group relief rules, referred to at 27 below). Although the relevant Budget Press Release indicated that it would 'level up the playing field between leasing and direct purchase', it appears to put finance leasing at a real disadvantage and certainly reduces the economic viability of short-term finance leases (which helps to explain why short leases did not need to be brought within the scope of the FA 2006 leasing regime – see 8 above). Moreover, whereas – in the past – it was preferable to incur capital expenditure as late as possible in the accounting period and hence to write new leasing business in a subsidiary close to its year-end, this will no longer be the case. Indeed, it would now appear to be preferable to incur the relevant expenditure as early as possible in an accounting period.

This time apportionment restriction originally applied only to finance leases. However, in the light of the fundamental reform of the leasing system introduced by FA 2006 (see, in particular, 5–11 above), the restriction is now extended to any operating lease which is a funding lease and has a term of more than four years but not more than five years. On the other hand, the restriction will no longer apply to a group company which shares the group parent's accounting reference date. These two modifications apply in relation to expenditure incurred on or after 1 April 2006: FA 2006, Sch 9, para 15.

The next point to note about writing-down allowances is that a pool system operates. This makes for ease of administration. Subject to certain exceptions (such as the current 10% pool for 'integral features' and long-life assets (see 22 below) and the separate pools for short-life assets and ships), all eligible expenditure is credited to the one pool and all disposal proceeds are debited to it. Therefore there is no need to identify the depreciation given on specific assets. Amongst other things, this means that (as a general rule) no balancing allowance is given when an item of plant or machinery is scrapped after a short useful life; the relevant expenditure will remain in the pool and carry on being written off over time.

The way in which the pool operates on general 20% allowance assets is as follows (see now CAA 2001, Pt 2 Ch 5). If, at the beginning of its first (12-month) accounting period (assumed to commence on or after 1 April 2008), a leasing company writes £10,000 worth of business, its first year's allowance will be in the amount of £2,000 and £8,000 will be carried forward. If, in the next period, its further eligible expenditure is £12,000, the pool will increase to £20,000 and the second year's allowance will be £4,000 and £16,000 will be carried forward. If, in the third period, it has eligible expenditure of £15,000 but disposes of equipment for £6,000, the net credit to the pool will be £9,000. The pool will go up to £25,000 and the third year's allowance will be £5,000 with £20,000 carried forward. The important point to note here is that sale or other disposal proceeds can be written off in full against what remains in the pool and the effect of this may be the same as a 100% first-year allowance in certain circumstances (especially if the proceeds of sale or disposal which are debited to the pool are matched by an equivalent rebate of rentals allowed in full as a trading expense).

The sale or disposal proceeds debited to the pool cannot exceed the original cost (CAA 2001, s 62(1)). Balancing allowances are only available on 'permanent discontinuance' of the leasing trade (CAA 2001, ss 55(4), 65(1)). An asset will accordingly never be fully written off over the lease period and the lessor will need to receive sale or disposal proceeds equal to the net balance in the pool attributable to the asset in question if residual expenditure is not to be left in the pool to be written off over time after termination. Rentals are usually calculated on the assumption that proceeds of the requisite amount will be received and this is generally spelt out as an underlying assumption in the documentation (failure to comply with which will result in a rental adjustment). Liquidation of a leasing company and/or sale of the business are rather drastic steps to take to achieve the same result but they are the only other way short of disposal proceeds on other transactions exceeding the assumed amount.

As mentioned above (see 16), expenditure incurred on an integral feature of a building or structure on or after 1 April 2008 is treated as 'special rate expenditure' for the purpose of CAA 2001, s 104A and will qualify for writing-down allowances at the current rate of 10% per annum, and such expenditure must in principle be allocated to a class pool (the 'special rate pool') pursuant to CAA 2001, s 104C. As explained below, long-life asset expenditure incurred on or after that date (and which also currently qualifies for 10% allowances) must also be allocated to this class pool. The disposal proceeds of the assets in question will have to be debited to the same pool (and not to the lessor's main pool).

In the specific context of leasing transactions, some detailed changes to the general rules on eligible expenditure and disposal proceeds have been introduced by FA 2010, Sch 5 in order to counteract certain perceived avoidance techniques. These appear to have involved lessors claiming allowances on the full cost of equipment while avoiding paying tax in the UK on the entirety of the lease rentals (generally by ensuring that they are non-UK resident when the bulk of the income from the lease accrues for tax purposes).

By virtue of the new CAA 2001, s 228MA, a lessor's qualifying expenditure on plant or machinery is now to be restricted to the present value of its income from the leased asset (plus the present value of the expected residual value in the asset immediately after the termination of the lease). For this purpose, the income from the asset is the aggregate amount that has been, or can reasonably be expected to be, received by the lessor in connection with the lease and brought into account as income for tax purposes. This new rule will apply where, at the time when the lessor's expenditure on the asset is incurred, there are arrangements in place for the asset to be leased and arrangements have been entered into in relation to payments under the lease that have the effect of reducing the value of the asset to the lessor (an example of such an arrangement being the assignment of the right to some of the rental payments).

A similar change is also made to the rules governing the disposal proceeds which must be debited to a lessor's pool. Under CAA 2001, s 64A, where plant or machinery is subject to a lease and the leased asset is sold (or, for example, the lessor becomes non-UK resident), the disposal proceeds for capital allowance purposes are to be calculated without regard to any arrangements that have been entered into and have the effect of reducing the disposal value of the asset insofar as it is attributable to rentals payable under the lease. In other words, the disposal value must be determined as if any such arrangements had not been entered into. So, for example, the disposal proceeds will have to be calculated on the basis that there has been no assignment of the right to rental payments.

21. SHORT-LIFE ASSETS

In order to forestall criticism that the prevailing 25% writing-down allowances were much too slow a rate of write down for fast depreciating assets (such as computers and some other office machinery), provisions were included in 1985 (now in CAA 2001, Pt 2 Ch 9) which enable a business to exclude from its general pool of capital expenditure

any asset which it believes will have only a short life, so that if the asset is subsequently scrapped after (say) three years, it will be fully written off for tax over that period. These provisions are useful to lessors on assets which could otherwise not have been economically leased because of the slow rate of tax depreciation otherwise available.

Where a person carrying on a trade incurs capital expenditure on the provision of machinery or plant and the relevant expenditure or asset does not fall within any of the excluded categories set out in CAA 2001, s 84 (see below), that person can (within two years from the end of the relevant accounting period) make an election under CAA 2001, s 83 requiring the equipment to be treated as a short-life asset. The broad effect of such an election is that a separate pool is created for the particular asset and a balancing allowance can be made on a disposal. If the disposal value of the asset is not brought into account in accordance with CAA 2001, s 61(1) within four years of the end of the period in which the original expenditure was incurred, then its tax written-down value at the end of that four year period will simply be transferred to the general 20% pool. The right to the special short-life asset balancing allowance on disposal will then be lost. In view of the two year time limit referred to above, lessors seem in practice to make short-life asset elections in respect of all relevant assets, bearing in mind that no adverse consequences flow from a failure to dispose of such assets during the four year period.

As mentioned, section 84 lists the circumstances in which equipment cannot be treated as a short-life asset. The policy behind this provision is that the assets which can be treated as short-life assets are, in the main, assets in respect of which first-year allowances used, in principle, to be available (prior to 1 April 1986). It follows, for example, that machinery or plant provided for leasing cannot be a short-life asset unless the equipment will be used for a qualifying purpose (within the meaning of CAA 2001, ss 122 to 125). Similarly, equipment leased by a non-trading lessor may not be treated as a short-life asset. In addition, 'special rate expenditure' within the meaning of the new CAA 2001, s 104A (see above) will not qualify for short-life asset treatment.

22. LONG-LIFE ASSETS – 10% WRITING-DOWN ALLOWANCES

Expenditure incurred on items of plant or machinery with an expected useful economic life when new of at least 25 years ('long-life assets') has in the past qualified only for a reduced allowance of 6% per annum on the reducing balance basis (see CAA 2001, ss 90 to 104), although this rate was raised to 10% per annum with effect from 2008/09 (see the new CAA 2001, Pt 2 Ch 10A, introduced by FA 2008, Sch 26, and see further below). The rate is scheduled to fall back to 8% per annum in respect of chargeable periods of companies ending on or after 1 April 2012. It was initially claimed, somewhat misleadingly, by HMRC that the introduction of a special rate for long-life assets would bring the tax treatment of such assets more into line with accountancy practice.

Expenditure on certain classes of asset is spared the effect of this rule. This includes expenditure incurred by the end of the year 2010 on sea-going ships or on railway assets (such as locomotives and rolling stock).

It should be noted that the *de minimis* limit of £100,000 of expenditure does not apply to expenditure incurred on the provision of machinery or plant for leasing (whether or not in the course of a trade). In effect, therefore, there is no such limit for lessors.

The legislation does not lay down very precisely how the expected useful economic life of an asset is to be determined. It merely provides that the useful economic life is the period which begins when the asset is first brought into use by any person and ends when that asset is no longer used (or likely to be used) as a fixed asset of a business – not necessarily the business of the person who first brought it into use (CAA 2001, s 91(3)). It follows that, despite the government's claim mentioned above, the accounting treatment (even where the owner of the

asset is not a finance lessor) may well not be a reliable guide as to the overall life of an asset, and there may be considerable scope for dispute with HMRC as to whether a particular asset is or is not a long-life asset.

A number of other uncertainties seem to arise from the definition of 'long-life asset'. For example, there will be obvious difficulties for a buyer of second-hand equipment in determining what the expected useful economic life was when that equipment was new. In addition, it is not clear what assumptions have to be made about the likely upkeep of the equipment. However, it would appear that if assets of a similar type are generally maintained to a high standard and the effect of such maintenance is to extend the life of the asset, this high level of maintenance will have to be assumed for the purpose of the long-life asset code.

Another issue is whether a single piece of equipment can be divided into its constituent parts, some of which have an expected economic life of at least 25 years (and are thus long-life assets) and some of which do not. In the article on long-life assets in the August 1997 Tax Bulletin, HMRC indicate that where the cost of replacing part of a larger asset would be allowable on revenue account as a repair, that constituent part may not be treated as a separate asset. They do, however, suggest that an aircraft's engines (which are likely to have a life of less than 25 years) may be treated separately from the aircraft itself, at least where those engines are readily interchangeable between aircraft and are interchanged in practice. More recently, HMRC have expressed a willingness to reach a pragmatic agreement with taxpayers (including lessors) under which jet aircraft capable of a configuration of at least 60 seats will effectively be treated as being 50% long-life asset and 50% not so, with the result that one-half of the full price of the whole aircraft in its 'ready for service' state will qualify for the full standard rate of writing-down allowances (currently 20%), the balance qualifying only for the 10% reduced rate. Disposal proceeds will be apportioned in the same ratio. According to the statement on this topic set out in the Tax Bulletin June 1999, pp 671, 672, taxpayers (including lessors) who wished to avail themselves of this treatment had to enter into a formal agreement with the Inland Revenue by 30 September 1999 (although this deadline is relaxed in cases where no expenditure on relevant jet aircraft subject to the long-life asset rules had been incurred by that date). Importantly, it appears that the agreement will have to apply to *all* such aircraft acquired by the taxpayer. It is understood that the agreement is in a standard form settled between HMRC and the British Air Transport Association ('BATA').

For the treatment of various other categories of aircraft which are not covered by the terms of the BATA agreement (such as regional jets with fewer than 60 seats, turbo-prop airliners and helicopters), reference should now be made to the Tax Bulletin December 2003, p 1075.

More generally, the original August 1997 Tax Bulletin article gives a number of examples of circumstances in which particular assets will, or will not, be treated as long-life assets and it also comments briefly on a number of the uncertain issues referred to above.

Expenditure which qualified only for the reduced 6% rate of writing-down allowance had to be pooled separately from the taxpayer's other expenditure on plant or machinery (see CAA 2001, s 101). This separate pool is described in the legislation as 'the long-life asset pool' and, in principle, all expenditure on long-life assets was allocated to that pool. This meant that such expenditure could not be set against disposal proceeds debited to the lessor's main pool of expenditure qualifying for the standard rate of allowances. A balancing allowance could arise only on permanent discontinuance of the leasing trade (or other qualifying activity).

As indicated above, the rate of writing-down allowance on long-life asset expenditure was increased to 10% per annum with effect from 2008/09. In the case of companies, the new rate applied from 1 April 2008. Unlike the change in the main rate of allowance, expenditure incurred on or after 1 April 2008 has attracted the new 10% rate even if the chargeable period in which that expenditure was incurred straddled that date. Accordingly, a 'hybrid'

rate was provided only for pre-existing long-life asset expenditure in the old 6% pool where the chargeable period in question began before and ended after 1 April 2008 (see FA 2008, s 83).

As in the case of the change in the main rate of allowance (see above), the hybrid rate is calculated on a time-apportioned basis. For a company with a 31 December year end, the hybrid rate for the 12-month period ending on 31 December 2008 is approximately 9%. The balance of unrelieved expenditure in the 6% pool at the end of this straddling period (or at 31 March 2008 for a company with a 31 March year end) is to be carried forward into the new 10% pool (see below).

Expenditure incurred on or after 1 April 2008 on long-life assets (which will qualify for 10% writing-down allowances) will be allocated to the new 10% pool. This new separate pool is described in the legislation as the 'special rate pool'. Expenditure incurred on or after 1 April 2008 on 'integral features' must also be allocated to this new 10% pool (see 16 and 20 above). As in the case of the old 6% pool, expenditure allocated to the new special rate (10%) pool may not be set against disposal proceeds debited to the lessor's main (20%) pool.

The above is subject to the reduction in the annual rate of allowance from 10% to 8% in respect of expenditure allocated to the "special rate pool", as announced in the June 2010 Budget and effective for chargeable periods of companies ending on or after 1 April 2012.

The long-life asset rules do not apply to expenditure incurred before 26 November 1996 or to expenditure incurred before 1 January 2001 in pursuance of a contract entered into before 26 November 1996. Nor do they apply to expenditure incurred on the acquisition of a second-hand long-life asset if the seller was not itself restricted to the reduced rate of allowances – for example, because the seller's expenditure on the asset was incurred before 26 November 1996 or because the seller acquired the asset from another person whose expenditure on the asset was incurred before that date (see CAA 2001, Sch 3, para 20). In these circumstances, 20% writing-down allowances will generally be available. In other circumstances, however, expenditure on second-hand long-life assets will qualify only for the reduced rate of allowances, even though the useful economic life in the hands of the acquirer could well be much less than 25 years.

23. SHIPS

Ships have always been given rather special treatment, the most recent, and perhaps most striking, example of this being the specific exclusion of some ship leasing from the ambit of the fundamental overhaul of the equipment leasing system introduced by FA 2006 (see below).

It was recognised at an early stage that first-year allowances gave shipping companies operating in periods of low profitability particular problems. They were heavy investors in assets qualifying for allowances and would rarely be able to use all the tax relief immediately. Rather than be forced to disclaim first-year allowances and take fixed 25% writing-down allowances to keep grouping flexibility, they were allowed to take their first-year allowances in instalments as and when they wished (the free depreciation system). Thus, at a time when 100% first-year allowances were available, they could take 20% in year 1, 40% in year 2 and 40% in year 3 if they wished according to the tax capacity available.

The 'free depreciation' system was subsequently extended to writing-down allowances on both new and secondhand ships (see now CAA 2001, ss 127 to 131). Obviously allowances in excess of the 20% available for a particular year cannot be claimed in that year, but any unclaimed allowance can be carried forward to a subsequent period and used in addition to the allowance then available. This is only likely to be attractive to leasing companies

if tax capacity has been miscalculated, although the value of insurance in this form should not be underestimated. Allowances postponed under these provisions will be available for group relief in the period in which they are actually claimed; such allowances will not be treated as 'brought forward from previous accounting periods' for the purpose of CTA 2010, s 101(3).

Some further flexibility for lessors and other shipowners was then introduced by the Finance Act 1995 (see now CAA 2001, ss 134 to 158). This makes it possible, in certain circumstances, for the payment of tax in respect of a balancing charge arising on disposal of one ship to be postponed and for that balancing charge, in effect, to be set against capital expenditure on ships incurred within the following six years. To qualify for this effective roll-over, a claim must be made by the taxpayer and both the old ship and the new ship (or ships) must satisfy the conditions set out in CAA 2001, ss 151 to 154 (in the case of the new ship(s), for a period of at least three years after being brought into use). For example, the ship must generally have a gross tonnage of 100 tons or more. This flexibility, which is obviously intended principally to assist shipping companies, may be of some help to equipment lessors, but, by definition, it will only be available in periods where tax is (or would, but for any carried-forward trading losses, be) payable in respect of the leasing trade. When available, however, this postponement of tax may certainly be useful, serving, in effect, to accelerate allowances on future ship leases. Moreover, it is possible for the roll-over to be effected by another group company incurring capital expenditure on new shipping within the six-year period.

The rules described in the preceding paragraphs are now subject to the tonnage tax regime introduced by FA 2000, Sch 22. This regime (which is optional) represents a radical reform of the tax treatment of shipping companies (and ships) and is a further example of the UK Government's continuing objective of assisting and supporting the British shipping industry.

It is beyond the scope of this article to describe in detail the rules laid down by Schedule 22 but, in brief, shipping companies may elect to have the taxable profits of their shipping activities calculated on the basis of the tonnage of the ships they operate rather than on normal corporation tax principles (accounting profits). Thus, where such an election has been made, the normal shipping profits are taken out of the charge to tax and are replaced by the so-called tonnage tax profits, which are calculated for each ship pursuant to a table set out in paragraph 4 (the taxable profit for a ship reducing in percentage terms as its tonnage increases). Corporation tax is then payable on the resulting profit at the normal rate. In order to be able to elect into the tonnage tax regime, a company must be within the charge to corporation tax, it must operate qualifying ships (i.e. seagoing ships with a gross tonnage of 100 tons or more, subject to certain exclusions) and those ships must be strategically and commercially managed in the UK (see Statement of Practice SP 4/00 on this latter requirement). In addition, the company must meet certain minimum requirements as to the training of seafarers. Whilst the ability to elect into the regime has for some time been restricted to companies *commencing* a shipping business, it has been provided by statutory instrument (pursuant to Sch 22, para 11) that any shipping company – i.e. even an existing company which previously chose not to elect – may make such an election at any time between 1 July 2005 and 31 December 2006. A tonnage tax election remains in force for ten years (subject to renewal). If no election is made by a company or group, normal corporation tax rules will continue to apply.

Given that the effect of a tonnage tax election is to take the profits of the ship operating trade out of a company's corporation tax computation (albeit that they are replaced by notional profits based on tonnage), it is hardly surprising that capital allowances are not available to companies within the tonnage tax regime in respect of expenditure incurred on ships or other assets for the purposes of the ship operating trade (see Part IX of Schedule 22). Nevertheless, the Government have been prepared to provide differently for lessors who lease qualifying ships to companies within the tonnage tax regime. In general, they will continue to be entitled to capital allowances (although subject to the monetary limits referred to below) and their financing costs will be allowable for tax in the normal way, thus ensuring that shipping companies within this regime will – at least to some extent – be able to

access lease finance. The specific rules governing the leasing of ships to tonnage tax companies are set out in Part X of Schedule 22.

When Part X was originally introduced, it applied only to finance leases. Accordingly, a lessor which leased a ship to a tonnage tax company on operating lease terms would, in principle, be entitled to full 25% writing-down allowances on the entire cost of that ship.

However, this distinction between finance leases and operating leases to tonnage tax companies has been eliminated by FA 2003, Sch 32. The reason for this appears to be that some lessors had been leasing very expensive ships to tonnage tax companies in circumstances where the lease in question qualified as an operating lease (as an accounting matter) but nevertheless contained many of the features normally associated with finance leases (such as a long duration). In order to put an end to this perceived exploitation of the fairly generous regime governing leasing to tonnage tax companies, the restrictions previously applicable only to finance lessors are now extended to operating lessors as well.

In the case of a lease of a qualifying ship to a company within the tonnage tax regime, the general rule (in paragraph 94 of Schedule 22) is that the lessor will be entitled to allowances on the first £40 million of its expenditure on that ship at the 20% rate (on the reducing balance) (the reduction from the previous 25% to 20% being by virtue of FA 2008, s 80) and on the next £40 million of expenditure at 10% (on the reducing balance). No allowances will be available on any remaining expenditure on that particular ship (so that, as stated in the original Revenue notes on these provisions, leasing is being allowed to remain available to support investment at the smaller end of the shipping market). It follows that the relevant expenditure has to be allocated to separate 20% and 10% pools. On the disposal of such a ship, the associated disposal value has to be allocated between these two pools in the same proportions as the original cost (paragraph 97). If the proportion of the disposal value allocated to the 20% pool is greater than the balance of qualifying expenditure in that pool, the excess is taken to the 10% pool. A balancing charge will arise only where the total amount of disposal value taken to the 10% pool is greater than the balance of qualifying expenditure remaining in that pool.

Special rules are included to govern the position where a lessee enters (or leaves) the tonnage tax regime during the currency of the relevant lease. Lessors will obviously need to ensure that their leasing agreements with shipping companies address the capital allowance implications for the lessor of the lessee's status changing during the term of the lease.

These monetary restrictions upon leasing to tonnage tax companies are now subject to two exceptions which are supposed to cover ordinary ship charters. These exceptions are set out in paragraph 89A of Schedule 22 (introduced by FA 2003, Sch 32, para 1(5)) and apply to leases entered into on or after 16 April 2003. The first exception is where the lessor remains responsible for operating the ship throughout the period of the lease, while the second exception is the lease of a ship for a period not exceeding seven years by a lessor acting in the course of a ship operating trade. Where either of these two exceptions is applicable, the monetary limitations on the expenditure qualifying for allowances are removed. Clearly, however, this is much narrower than an exception for all operating leases.

Quite apart from these quantitative limitations on the lessor's entitlement to allowances, it is provided in Part X that no allowances at all will be available in either of two circumstances. The first disentitlement arises where the whole or the greater part of the lessor's risk of the lease payments not being made is in some way defeased (paragraph 90). However, the provision of security by the lessee (or its affiliate) or by a third party is, in certain circumstances, permissible (although not, in general, where money or other property is deposited with the lessor); and guarantees or other security provided by the lessor's parent are ignored. The second disentitlement arises where the qualifying ship is

purchased from the tonnage tax company and leased back to it, unless the ship is newly built and the purchase by the lessor takes place within four months of its first being brought into use (paragraph 92).

By virtue of paragraph 93, a lessor and lessee must provide a joint certificate to HMRC in support of any claim to allowances in respect of a qualifying ship. The certificate must state either that the ship is not leased to a company within the tonnage tax regime or that (where it is so leased) neither the defeasance nor the sale and lease-back provisions apply to deny allowances altogether.

As indicated above, these specific rules governing leasing to tonnage tax companies are designed to maintain the viability of lease finance at the smaller end of the market. Where a ship costs much more than £80 million, it is unlikely that leasing will be attractive, bearing in mind that no allowances will be available on the excess cost (over the £80 million) while the lease rentals will remain taxable in full in the lessor's hands.

24. FA 2006 regime

Following the enactment of FA 2006, there is almost certain to be even greater interest in leasing to companies within the tonnage tax regime (see Sch 9, para 10). This is because the general position is that leases of qualifying ships to tonnage tax companies will not be treated as long funding leases for capital allowance purposes even if the relevant lease would otherwise have been a long funding lease (see 8 above). The effect is that lessors will continue to be entitled to allowances under the rules described above (including the monetary limits etc.) and this particular sector of the leasing market will remain viable.

In order to achieve this result, FA 2006 has inserted into FA 2000, Sch 22 the new paras 91A to 91F. The basic rule set out in para 91A is that a lease will not be a long funding lease (and will thus fall outside the ambit of the new leasing regime introduced by FA 2006) if that lease satisfies (and continues to satisfy) each of three essential requirements. These are:

(a) that the lease is a lease of a qualifying ship provided directly to a company within tonnage tax (an indirect lease through one intermediate lessor in the same group as the relevant tonnage tax company is also permitted) (para 91B);

(b) the lessee (i.e. the tonnage tax company) must be responsible for the operation of the ship and for the defraying substantially all expenses in connection with the ship (see para 91C for the detail); and

(c) where the ship is sub-leased to a company not within tonnage tax (or, alternatively, the lessee enters into a contract of affreightment with such a company providing for the carriage of goods by the ship), the amount payable under the sub-lease (or contract) must be a market rate and the period of the sub-lease (or contract) must not exceed seven years. There are detailed rules pursuant to which the 'period' of the sub-lease is to be determined.

It is sufficient for there to be an expectation that these requirements will be satisfied when the ship is first brought into use under the lease. Also, the requirements in (b) and (c) above do not need to be satisfied if the lease was finalised (i.e. generally speaking, an unconditional agreement for lease was entered into) before 1 April 2006. It is stipulated that, if applicable, the para 93 certificate (mentioned above) must state that para 91A has the effect that the lease is not a long funding lease.

A slightly curious anti-avoidance provision has been included in para 91E in order to ensure that leasing arrangements intended to circumvent the main restrictions upon a lessor's entitlement to allowances in respect of

a ship leased to a tonnage tax company (e.g. the monetary limits described above) will not be excluded from the ambit of the FA 2006 leasing regime. The relevant lease will not be treated as not being a long funding lease.

In summary, whilst this obviously remains to be seen, it seems quite likely that the overall result of these reforms will be a highly competitive ship leasing market.

25. ASSETS LEASED TO NON-RESIDENTS

In the past, where plant or machinery has been leased to a non-resident lessee outside the UK tax net (i.e. the equipment has been used for 'overseas leasing' within the meaning of CAA 2001, s 105(2)), the lessor's writing-down allowances have generally been restricted to a maximum of 10% on the reducing balance (CAA 2001, s 109). As explained in 4 above, concern that this restriction may well not be EU compliant contributed strongly to the impetus for the fundamental reform of equipment leasing introduced by FA 2006. By transferring the basic entitlement to capital allowances from the lessor (under a long funding lease) to the lessee, there was no longer any need to have a special regime for leasing to non-residents. UK allowances would clearly be of no interest to a non-resident lessee outside the UK tax net, so that (in general terms) there would be no danger of UK tax benefits being exported overseas through such a leasing transaction.

It is therefore provided by FA 2006, Sch 9, para 13 that in determining whether an asset is used for overseas leasing, no account is to be taken of any lease finalised on or after 1 April 2006. In broad terms, a lease is treated as finalised either on the date on which the parties enter into an unconditional agreement for lease or, where a conditional agreement has been entered into, at the time when the conditions have been satisfied (Sch 8, para 23). It follows that the 'overseas leasing' code will not apply to any lease which is outside the scope of the 2006 reforms (so that the lessor is entitled to capital allowances) and is finalised on or after 1 April 2006. This will be relevant, in particular, to lessors under operating leases which are not treated as funding leases under FA 2006, short leases and some leases that are grandfathered under the FA 2006 transitional rules (see 5–11 above). Consequently, there would appear to be at least some potential for the leasing industry to access new (overseas) markets, particularly in the field of operating leasing.

The one caveat to the above is that where an asset has previously been leased to an overseas lessee and the lessor has accordingly been restricted to 10% allowances, it will make no difference that a new lease of the asset is finalised on or after 1 April 2006. The restriction will continue to apply.

In circumstances where the old 'overseas leasing' regime remains potentially relevant (e.g. in the case of a lease to a non-resident which is grandfathered under the FA 2006 transitional rules but was finalised before 1 April 2006), it will be essential – if the restriction to 10% allowances is not to apply – that the non-resident lessee uses the equipment for the purposes of earning profits which are taxable in the UK (and are not relieved under an applicable double taxation agreement). This rule is intended to ensure that, for example, 20% allowances cannot be claimed in respect of assets leased to UK branches of non-resident companies which are, under domestic law, within the UK tax net but which, by virtue of a double taxation agreement, do not have to pay tax in the UK. This would, for instance, be relevant to non-resident aircraft and shipping operators which may carry on a trade in the UK through a permanent establishment and yet still be relieved under treaty provisions from any UK tax liability in respect of profits attributable to that permanent establishment. This restriction will not, however, apply to expenditure incurred in the case of the leasing of a ship, aircraft or transport container which is used for a qualifying purpose by virtue of the specific provisions relating to those assets in CAA 2001, s 123 or 124. The general restriction of writing-down allowances to the 10% rate, provided for by CAA 2001, s 109, was the first stage of the legislative attack on foreign leasing transactions.

The second stage of this attack can be seen in CAA 2001, s 110, which denies allowances altogether on certain assets leased to foreigners in circumstances where:

(a) a period of more than one year elapses between the date on which any two consecutive payments become due under the lease;

(b) any payments other than periodical payments are due under the lease or under any agreement which might reasonably be construed as being collateral to the lease. This will catch leases under which lump sum payments are made in exchange for reduced rental payments and other stepped rental or rear-end loaded deals;

(c) the rental payments vary except in certain limited circumstances which may have been intended to, but do not, cover all tax and interest rate adjustment provisions in a typical finance lease;

(d) the lease is expressed to be for a period which exceeds thirteen years or there is provision for extending or renewing the lease or for the grant of a new lease so that the plant or machinery could be leased for a period exceeding thirteen years; or

(e) the lessor or a connected person will or may become entitled to receive a payment of an amount, determined before the expiry of the lease and which is referable to a value of the equipment at or after its expiry. This catches terminal rental subsidy payments geared to an expected residual value of the plant or machinery which, if not realised, is paid over in cash. It may, however, catch early termination rental payments.

It was thought when the forerunner of section 110 was originally introduced that it was intended simply to limit abuse of finance leasing to foreigners by minimising the UK advantage. The relevant provision was included in the 1982 Finance Bill at a late stage and shows signs of hasty drafting (as illustrated very clearly by the recent litigation in *BMBF (No 24) Ltd v IRC [2003] EWCA Civ 1560, [2004] STC 97*, discussed in detail in *Tolley's Tax Planning 2005–06*). It is therefore most disappointing that no attempt whatsoever was made in CAA 2001 to clarify or modify the list of offending circumstances introduced back in 1982 (and summarised above). In practice, HMRC have taken advantage of this provision and limited the scope of the exclusions. Careful attention should, therefore, be paid to the wording of the lease and any ancillary documentation in the context of section 110 if 10% writing-down allowances are sought. Stipulated termination rentals will, for example, be impossible, as will certain rental adjustment provisions based on more general tax or funding changes. However, allowances will not be completely denied unless the machinery or plant in question is used otherwise than for a qualifying purpose within the meaning of CAA 2001, ss 122 to 125.

Given the background to the changes introduced by FA 2006, it is noteworthy that in May 2007 HMRC issued a press release stating that they accepted that 'in some circumstances' the rules in CAA 2001, ss 109 and 110 may be contrary to Community Law. More specifically, HMRC have said that, where equipment is used for overseas leasing and the lessee is resident in an EEA jurisdiction, then:

(i) where the relevant EEA jurisdiction grants to the lessee a relief that is 'broadly equivalent' to capital allowances, HMRC will apply s 109 (as in the past) to restrict the rate of writing-down allowances to 10% but will not apply s 110; and

(ii) where the EEA jurisdiction does not grant such a relief to the lessee, HMRC will accept that the lessor is entitled to the full standard rate of writing-down allowances.

On this basis, HMRC say that they have decided not to contest certain past claims for allowances.

Expenditure which is eligible for 10% writing-down allowances pursuant to the overseas leasing code must be allocated pursuant to CAA 2001, s 107 to a separate pool comprising all such expenditure. This prevents the lessor from accelerating such allowances by using them to off-set balancing charges in the lessor's main pool (see above for how this can happen). Once all the relevant equipment has been disposed of or has begun to be used wholly or partly for purposes other than those of the leasing trade, a balancing allowance can arise.

26. SALE AND LEASE-BACK

The traditional rules on plant and machinery allowances have always been modified in the context of sale and lease-back transactions. The special rules were originally intended mainly to deny first-year allowances to the lessor and therefore became less significant, in themselves, once first-year allowances were abolished in the 1980s. However, in the 1990s, the Revenue directed their attention once again to sale and lease-back transactions, and further significant restrictions on a finance lessor's entitlement to allowances (i.e. writing-down allowances) were announced in the July 1997 Budget. These extended restrictions have operated to the detriment of those lessees (or prospective lessees) who do not put their leasing arrangements in place early enough or who need to obtain lease finance at a later stage in a project. Naturally, where the lease-back is a long funding lease within the meaning of CAA 2001, Pt 2 Ch 6A, the lessor will have no entitlement to allowances in any event and will therefore be unaffected by these special rules.

The extended restrictions introduced in 1997 were themselves exploited by some taxpayers and, although the Government attempted to address this by making subsequent changes to the system (most notably in FA 2004), it became evident by the time of the 2007 Pre-Budget Report that a substantial overhaul of the sale and lease-back regime was required. Some fundamental changes were therefore announced at that time and these have been implemented by FA 2008 – see Sch 20, para 6. The new rules apply to equipment which is the subject of a sale and finance lease-back (see further below) in circumstances where the date of the sale of the equipment (or other relevant transaction: see CAA 2001, s 213) is on or after 9 October 2007. In circumstances where the sale (or other relevant transaction) took place before 9 October 2007, the rules in force immediately prior to the enactment of FA 2008 will continue to apply. This article, however, proceeds on the basis that the transaction will occur on or after 9 October 2007.

The original pre-1997 restrictions in relation to sale and lease-back transactions do, however, remain applicable today and apply where capital expenditure is incurred on the provision of plant or machinery which continues to be used for the purposes of a trade (or other qualifying activity) carried on by the seller/lessee or any connected person (CAA 2001, s 216, as amended by FA 2009, Sch 32). For this purpose, the lessee's trade (or other qualifying activity) need not be within the UK tax net. In these circumstances, the amount on which the purchaser/lessor may claim writing-down allowances will be limited to the disposal value accruing to the seller as a result of the sale: CAA 2001, s 218(1)(2). The effect is, therefore, to restrict the purchaser's writing-down allowances to the original cost incurred by the seller (at the most). Where the seller does not have to bring any disposal value into account (e.g. because he does not pay UK tax), the purchaser's allowances will in general be limited to the lowest of the open market value of the asset in question at the date of the sale, any capital expenditure incurred on the provision of the asset by the seller (or a connected person) and the price actually paid by the purchaser. However, none of these restrictions will apply where the purchaser/lessor acquires unused equipment from its manufacturer or supplier (see CAA 2001, s 230).

A key point, however, is that the restrictions provided for by s 218 do not apply where the equipment is the subject of a sale and finance lease-back – in other words, where the lease-back is a finance lease (as defined in

CAA 2001, s 219). The basic reason for this is that, under the FA 2008 regime, all leases in sale and finance lease-back transactions will in principle be treated as long funding leases. This will mean that the relevant lessor will have no entitlement to capital allowances, so that the restrictions provided for by s 218 (and others repealed by FA 2008) will not need to be applicable to such transactions. The way in which leases in sale and finance lease-back transactions are treated as long funding leases is by providing that such leases (which must, by definition, be funding leases under the FA 2006 regime) can never be short leases: see the new CAA 2001, s 70I(10). There is, however, one exception to this rule (relevant to new or practically new equipment subject to a short lease: see further below).

The concept of a sale and finance lease-back is defined in CAA 2001, s 221. It is essentially the same as the basic concept of a sale and lease-back (described in s 216, referred to above) except that (i) the seller/lessee's use of the asset need not be for the purposes of a trade (or other qualifying activity); and (ii) the lease in question must be a finance lease as defined in CAA 2001, s 219.

The restrictions imposed by s 218 – and the much more severe restriction provided for by CAA 2001, s 70I(10) where the lease-back is a finance lease – apply not only to an outright sale of the asset by the prospective lessee to the lessor but also, in particular, to the assignment by the prospective lessee to the lessor of the benefit of a contract under which the lessee would or might have become the owner of the asset (CAA 2001, s 213(1)(c)). It follows that even where title to new equipment has not yet passed to the prospective lessee, it may strictly be very difficult to avoid the application of these restrictions if the lessee has already entered into a contract for the purchase of that equipment. The lessor would, in some way, have to be provided with the benefit of the contract and the likelihood is that this would generally involve an assignment for the purposes of section 213(1)(c). However, HMRC have provided some assistance on this point in their June 1998 Tax Bulletin. They state that the restrictions will not apply where the benefit of the contract is *novated* to the lessor (in the strict sense of the original contract being substituted by a new one) before the asset has been brought into use by the lessee, provided that the lessee has not claimed, and will not claim, allowances on that asset.

As mentioned above, there is an exception to the new rule in CAA 2001, s 70I(10) deeming a short lease comprised within a sale and finance lease-back not to be a short lease (and thus, in effect, to be a long funding lease under which the lessor cannot be entitled to any allowances): see the new s 70I(11)(12). This exception applies to the sale and lease-back of new or almost new equipment. Where the sale of the asset (or the assignment of the benefit of the relevant contract) to the lessor is effected not more than four months after the time when the asset was first brought into use, the lessor and the seller/assignor may elect that the lease (if it would otherwise be a short lease) will not be deemed to be a lease that is not a short lease.

The effect of such an election will, therefore, be that the lease will not have to be deemed to be a long funding lease and that the lessor may be entitled to claim capital allowances. In addition, the election will have the effect that the amount on which the lessor may claim allowances will be restricted only to the lower of the price paid by the lessor and the capital expenditure incurred on the asset by the seller/assignor (or a connected person) – i.e. disregarding the market value of the asset. Various conditions need to be satisfied if this election is to be available: see CAA 2001, s 227(2). For instance, the seller/assignor must not itself have claimed allowances in respect of the relevant asset. Where the election is available, it will obviously be helpful to those who, for one reason or another, have not been able to put their leasing arrangements in place at a sufficiently early stage to avoid completely the impact of the sale and lease-back provisions.

The treatment described above represents a substantial modification (by FA 2008) of the rules governing sale and finance lease-back transactions introduced in 1997. However, one of the fundamental changes introduced in 1997 has been left in place (although it will be appreciated, from what is said above, that the following will be relevant

only where the finance lease-back is a short lease and is not deemed to be otherwise). By virtue of CAA 2001, s 225, capital allowances are completely denied to a finance lessor under a sale and lease-back in circumstances where the effect of the overall arrangements is in some way to remove from the lessor the whole (or the greater part) of the risk of the lessor sustaining a loss under the leasing transaction by reason of lease payments not being made in accordance with the terms of the lease (such risk having been referred to in CAA 1990 as the 'non-compliance risk'). This rule is obviously likely to deny allowances to a finance lessor where the lessee is required to deposit a cash sum with the lessor as security for the lessee's obligations under the lease; and it may well have the same effect in relation to various other comparable forms of defeasance arrangement.

What has been somewhat less clear is whether this rule extends to the provision of a bank guarantee. It seems rather more difficult to say that the risk in question has been 'removed' where the effect of the arrangement is that the lessor has taken a credit risk on the bank. Indeed, if the mischief at which this rule is directed is the utilisation by the seller/lessee of the proceeds of sale of the asset for the purpose of protecting the purchaser/lessor against the risk of financial loss, it is a little difficult to see why non-cash-backed bank guarantees should be intended to be caught. The legislation does, however, make it clear that guarantees from persons connected with the lessee may be ignored (which could be taken to indicate that third party guarantees may not); and it is clear that – at the very least – HMRC will not accept that bank guarantees are as a matter of principle outside the scope of section 225. Reference should be made to the June 1998 Tax Bulletin (at page 544), which sets out the limited circumstances in which, according to HMRC, third party guarantees (whether or not cash-backed) may be ignored for the purposes of this provision.

One of the obvious difficulties here is that the legislation is silent on the question of how to quantify whether the 'greater part' of a non-compliance risk has been divested. HMRC have confirmed that the risk to the lessor must be reduced by more than 50%, but there would still appear to be considerable scope for dispute over the way in which the reduction of risk is to be measured. It is, for example, arguable that the risk should be measured by reference to the maximum termination sum payable under the lease but, in the absence of clarification from HMRC, this cannot be relied upon. Unfortunately, the relevant Tax Bulletin article does not shed much further light on this aspect. More recent indications are that the residual value of the asset should be factored into these calculations, but that simply introduces further imponderables. The lessor is exposed to the fact that the residual value may be zero. The residual value will not be known until it is realised.

With effect from 12 March 2008, lease and finance lease-back transactions (which are essentially defined in CAA 2001, s 228A) will be subject to the new CAA 2001, s 70I(9A), the effect of which is that the finance lease-back – and any other finance lease forming part of the overall arrangement other than the head-lease – may never be a short lease. This means that all such finance leases will be long funding leases and that the finance lessor will in no circumstances be entitled to capital allowances.

The final point to note about sale and finance lease-back transactions (involving plant or machinery) is that they are specifically excluded from the ambit of the otherwise broad anti-avoidance regime governing so-called 'finance arrangements' (previously 'structured finance arrangements') and now set out in CTA 2010, ss 758-776: see, in particular, s 771(7)-(9). Accordingly, the sale and finance lease-back of plant or machinery will be taxed in accordance with the rules described above. Lease and finance lease-back transactions are also excluded from the ambit of the legislation governing 'finance arrangements'.

27. UTILISING THE ALLOWANCES

Tax relief is only any use if it can be set against taxable profits. This part of the article analyses how that can be done.

It is usual for companies to carry on their leasing activities through a subsidiary. Relief for trading losses (which, of course, include losses created by capital allowances) may be surrendered by one member of a group of companies to another member of the same group provided that the requisite group capital structure exists. A detailed discussion of all the rules relating to group relief is obviously beyond the scope of this article. However, there are certain points that are particularly relevant in the present context.

To the extent that the lessor itself is unable to absorb allowances in the period in which they arise, it may surrender any loss created to another member of the group which will then be able to set off such loss against its profits of the corresponding period (subject to the rules mentioned below). Allowances which, though claimed, are not used for offset or group relief in the accounting period in which they arose may be carried forward indefinitely and offset against future profits of the same trade (and CTA 2010, s 37 and s 39 provide a more limited right of carry-back against profits from all sources). Allowances may not be surrendered by way of group relief after they have been carried forward. However, CAA 2001, s 56(5) does allow companies to claim less than their full entitlement to allowances and thus to obtain higher allowances in years when they may be more useful for group relief purposes. In each case, the lessor will have to decide whether it will be more beneficial to carry forward excess allowances as losses in the same trade or to claim an amount less than the permitted maximum and then receive correspondingly greater allowances at a time when they can be utilised for group relief purposes. One would usually expect the latter to be the case but it will depend on the facts.

Care should be taken that the structure of the lease does not prejudice the group relationship. Cash-rich lessees whose non-tax paying position makes lease finance attractive occasionally seek to improve the lease terms available to them by offering to finance the lessor. Such finance is treated as 'equity' in the lessor for the purposes of determining whether a group relationship exists (CTA 2010, s 159) and lessee financing will, almost always therefore, reduce the interest of the lessor's parent in the profits or assets of its subsidiary to below the critical 75% level (CTA 2010, s 151(4)). The high debt/equity ratios of most leasing subsidiaries can cause relatively small amounts of lessee financing to destroy the lessor's tax relationship with the rest of its group. Limited or non-recourse finance is caught in exactly the same way. Thus a subsidiary lessor cannot borrow money on terms that the obligation to pay interest will be abated if the lessee fails to pay rent (see also the deemed distribution provisions in CTA 2010, Pt 23 Ch 2 which may be relevant).

If it is intended to set up a new leasing subsidiary, it is important to note that the first 20% writing-down allowance will be scaled down if, as mentioned above, the initial accounting period is less than twelve months in length. It is no longer possible to solve this problem by employing a company with an existing non-leasing trade (see CAA 2001, s 56(4)). It therefore seems that the only complete solution to this problem is to use a company with an existing leasing trade (perhaps by arranging for the new subsidiary to enter into a number of small leasing transactions in advance of the period in which the first main transaction is to be undertaken).

Following the establishment of a separate subsidiary, it used to be possible for the early utilisation of losses arising in it to be accelerated by careful use of the group relief corresponding period provisions. However, the combined effect of the Finance (No 2) Act 1997 changes time-apportioning the expenditure eligible for capital allowances in the period in which that expenditure is incurred (now CAA 2001, s 220) and amending the group relief corresponding period provisions has been to reduce very substantially the scope for such acceleration of losses.

As far as group relief is concerned, the point was that the old rules operated on a company by company basis within the group. Thus, whilst the ability to set losses against the profits of another group company with a different year-end was subject to time apportionment restrictions, those restrictions operated separately between each pair of companies within a group. So, where there were several profit centres against which relief could be claimed (with different accounting periods), it might be possible for the loss-making company (i.e. the leasing company)

to surrender 100% of its losses for a period against the profits of other group companies for periods ending prior to the loss-making company's year-end. That would have produced an effective acceleration of relief, which is now prevented by the amendments introduced in 1997. The current rules ensure that the time apportionment restrictions operate on a group basis, by limiting the *aggregate* of claims or surrenders which can be made in respect of any part of an accounting period. Whilst it is difficult to complain about this legislative change, it does clearly mean that it is now more difficult for leasing groups to manage their tax capacity.

Even where there are no particular advantages to be derived from using a leasing subsidiary, it should be noted that leasing is almost certainly to be regarded as a separate trade, so carry-forward losses will be locked into that separate trade and there will be no advantage on this account from using the same company for leasing activities.

One question that may arise in the case of joint leasing ventures is whether the parties should operate as a consortium or form a partnership or simply try to set up a joint ownership structure.

Despite certain relaxations in the law over the years, consortium companies tend still to be cumbersome and relatively inflexible, especially in start-up years and as regards termination. They are rarely suitable for one-off projects. A company which is a member of a partnership will bring into its corporation tax computation its share of the partnership profit or loss (as if that share derived from a trade carried on by the company alone in its corresponding accounting period or periods) and partnership losses may be offset against the profits of the same accounting period of other companies in the partner's group. Partnerships are not subject to the same group or consortium relief apportionment rules on set-up as subsidiaries or consortium companies are. This means that they can often be set up on short notice late in an accounting period. As a general rule, therefore, partnerships are more attractive than consortium companies.

Joint ownership arrangements are not recommended. While there may be circumstances in which joint ownership does not amount to a partnership for tax purposes, these must be few and far between (see *Farrell v Sunderland Steamship Co Ltd 4 TC 605*) and it must be more prudent to tax plan on the basis that a partnership exists.

28. FINANCING THE LEASING BUSINESS

As will have become clear, finance leasing is all about obtaining finance and making it available on an asset-linked basis to lessees. A lessor will get its finance usually from two sources (equity or share finance being rare).

(i) Rentals – often paid in advance, thereby reducing the initial cost. As already mentioned, the basis of taxation is critical. An accruals basis will usually produce the best result but even then the method by which accruals are to be recorded will have to be agreed with the local inspector. A leasing company's accounts will provide little guidance on this because of the specialised basis of accounting for lease transactions (and, as mentioned at 33 below, Statement of Practice SP 3/91 will not be relevant).

 The tax treatment of rental income is discussed further at 29 *et seq*. below.

(ii) Loans. The potential defects of limited or non-recourse loans have already been pointed out, and they have certainly been under close HMRC review in recent times, especially in connection with film leasing. A guarantee of lease rentals from the lender is a better route to follow. Non-recourse finance will have to be viewed with even greater caution in the light of the decision of the House of Lords in *Ensign Tankers (Leasing) Ltd v Stokes 64 TC 617*, although it does at least remain the case (as supported by *dicta* in that decision) that the financing of expenditure by a non-recourse loan will not *of itself* prevent that expenditure from qualifying

for capital allowances – a point very much reinforced by the Court of Appeal decision in *Tower MCashback LLP1 v Revenue and Customs Comrs [2010] STC 809*.

Other loans should not, in principle, cause problems. However, when the corporate debt legislation was introduced in 1996, there was a degree of concern within the leasing industry about the possible impact upon equipment leasing of the anti-avoidance rule now contained in CTA 2009, ss 441–442. This provision precludes relief for interest to the extent that the interest is attributable to an 'unallowable purpose'; and it is provided that the relevant borrowing has an 'unallowable purpose' if the main purpose or one of the main purposes for which the borrower has entered into that borrowing consists in securing a 'tax advantage' (adopting the broad definition of that term in CTA 2010, s 1139). In the leasing context, of course, the fundamental concern about this provision arises from the importance of the lessor's capital allowances and interest relief to the overall financial efficiency of lease financing. However, whilst there remains considerable uncertainty as to the general scope of CTA 2009, ss 441–442, statements made by the Economic Secretary to the Treasury during the passage of the 1996 Finance Bill provide substantial reassurance that equipment lessors will not in practice be denied interest relief merely because of these essential elements of straightforward tax-based leasing transactions (see Hansard Standing Committee E 28 March 1996, col 1192).

29. TAXATION OF LESSOR'S RECEIPTS – RETURNS IN CAPITAL FORM AND NEGATIVE DEPRECIATION

Reference has already been made in general terms to the tax treatment of rental income. During the course of 1996, however, two particular issues relating to lessors' returns came to the Revenue's attention and ultimately led to the announcement in the November 1996 Budget that new rules would be introduced to prevent finance lessors converting rental income into capital receipts or (as the government viewed it) obtaining a deferral of tax on rental income in certain circumstances. These rules, which were originally enacted in FA 1997, are now set out in the lengthy CTA 2010, Pt 21. The provisions are complex and of potentially broad scope, and they also impinge, in the case of the first of the two issues, on the lessor's treatment under the capital allowance code.

Not surprisingly, however, these rules do not apply to the lessor under a lease which is a long funding lease within the meaning of the FA 2006 reforms: CTA 2010, s 901(2) and s 927(3).

30. Finance leases with return in capital form

In general, the rental payments under a finance lease are such that the full cost of the asset plus an amount equivalent to interest are returned to the lessor. However, some finance leases have provided for lower initial rental payments and a subsequent compensating capital sum. The capital sum may, for example, be paid on the exercise of an option requiring or allowing the lessee to acquire the asset (directly or indirectly) from the lessor. Whilst, for accounting purposes, the interest element of all the payments (including the compensating sum) is treated as income spread over the life of the asset, the pre-FA 1997 tax treatment was that the compensating sum (including any interest element) would generally be taxed only on receipt and not as income (but rather as capital which might be sheltered by the lessor's base cost for the asset and indexation relief). This particular scheme appears to have been popular with tax-exempt bodies requiring property finance (bearing in mind that they would have received no tax relief for normal rental payments). Typically, however, the legislation does more than just abolish this specific scheme: it is capable of applying to any finance lease of equipment or other property in widely-drawn circumstances. In accordance with the recent vogue, the stated intention behind the new rules is to align the tax treatment of the relevant payments more closely with their accounting treatment.

The relevant rules are set out in CTA 2010, Pt 21 Ch 2. A thorough review of these provisions is beyond the scope of this article. However, the main features are as follows.

Chapter 2 of Part 21 applies to leases of assets in relation to which five specified conditions are satisfied. HMRC have confirmed that these conditions have to be satisfied simultaneously. The conditions, which are set out in CTA 2010, s 902, are that:

(a) the lease (and any related arrangements) would be treated in accordance with generally accepted accounting practice as a finance lease (or a loan);

(b) there is or may be payable to the lessor (or to a person connected with the lessor) a sum which is not rent but would fall to be treated in accordance with generally accepted accounting practice as, in part, repayment of some or all of the investment under the finance lease and as, in part, a return on that investment (such sum being described as a 'major lump sum');

(c) at least part of the sum which would fall to be treated as a return on such an investment would, under normal rules, *not* be brought into account for tax purposes as the 'normal rent' from the lease (the 'normal rent' for a period being the amount which the lessor would, under pre-Budget rules, bring into account as rent from the lease for the purpose of determining his tax liability);

(d) the so-called 'accountancy rental earnings' in respect of the lease exceed the normal rent for the current accounting period of the lessor (or a previous accounting period during which he was the lessor). The accountancy rental earnings will, in general, be the amount which in the lessor's accounts or consolidated group accounts falls to be treated in accordance with generally accepted accounting practice as the gross return for the relevant period on the lessor's investment in the finance lease; and

(e) there are arrangements under which the lessee may acquire the leased asset from the lessor and the lessor may receive from the lessee a sum which is not rent but at least part of which would fall to be treated in accordance with generally accepted accounting practice as a return on the investment under the finance lease (the references to lessor and lessee including connected persons). It is not necessary that such a sum is actually received by the lessor.

Whilst it is true that all five conditions have to be satisfied before this regime comes into play, the conditions are framed in broad terms and it seems inevitable that some conventional forms of leasing transaction (involving no intention to convert rental income into capital) will, depending on the precise circumstances, be capable of falling within their scope. An obvious example is the perfectly common scenario in which the lessor has the benefit of a put option over its interest, which may be exercisable in the event of default by the lessee or (for instance) in the event of the leased asset becoming an environmental liability. Yet, in these circumstances, the likelihood is that the lessor will derive its return from the rental payments (because the option will never become exercisable). It is disappointing that HMRC have not issued a public statement making it quite clear that conventional arrangements of the sort just referred to will not be caught.

Where Chapter 2 of Part 21 applies, the basic rule (set out in CTA 2010, s 905) is that the lessor is to be treated for tax purposes as if he had been entitled to rent of an amount equal to the accountancy rental earnings for the period in question (i.e. the gross return on the investment for accounting purposes) instead of the normal rent (where the former is greater than the latter). There then follow some complex rules which are intended to ensure that the same income is not taxed twice – for example because, in a subsequent period, the normal rent exceeds the 'accountancy rental earnings'. Nevertheless, while the detail is undoubtedly intricate, the principle that the interest element of both the rental payments (such as they are) and the capital sum should be treated as the lessor's minimum taxable income and spread over the period of the lease is clear enough.

As indicated above, however, this anti-avoidance provision goes further than this. Where a 'major lump sum' actually falls to be paid in respect of the leased asset (see condition (b) summarised above), a lessor who has been claiming plant and machinery allowances will have to bring into account disposal value equal to the amount of the major lump sum or, if less, the original cost of the asset (and there are equivalent rules applicable where other allowances, such as industrial buildings allowances, have been claimed) (see CTA 2010, ss 917-922). It does not matter whether the major lump sum is paid to the lessor on a straightforward disposal of the leased asset or by some more circuitous route. In other words, these rules ensure that the sum concerned will be debited to the lessor's capital allowance pool and cannot escape taxation as income by being structured as something other than disposal proceeds of the leased asset. This would certainly appear to stamp out the sort of schemes which provoked the introduction of this legislation. The difficulty, of course, is that (as mentioned above) the rules are capable of applying to more conventional leasing transactions and it is not clear that lessors are adequately protected against being taxed in respect of the 'interest element' of the major lump sum both under the rule described in the preceding paragraph (i.e. as deemed accrued rent) and, on receipt, through the capital allowance pool. Some further comfort from HMRC, over and above the very general comments made in the April 1997 Tax Bulletin, would certainly be welcome in this area.

31. Negative depreciation

The other issue which attracted much Revenue attention during 1996 was the tax treatment of leases having a 'stepped' rental profile. Leases may, for example, be structured in this way in order to enable lessees to align increasing income from a new project with increasing rental expenditure. The potential economic effects of this can be seen by adjusting the graph at 2 above.

However, from the lessor's point of view the effect may well be that the rent received in the early years is somewhat less than the gross earnings which it is required to record under SSAP 21. In these circumstances, the lessor will avoid creating an accounting deficit by crediting the shortfall to its profit and loss account (the relevant entry being known as 'negative depreciation' and effectively recognising the value of the deferred rental receipt or increasing value of lease rights). For most of 1996, the Revenue contended strongly that such negative depreciation was taxable in the period in which it was credited, presumably on the basis that the process was, in effect, and accrual of future rental income. This view was resisted equally firmly by the leasing industry and, perhaps recognising the weaknesses in the Revenue's argument (under existing law), the Chancellor announced in the November 1996 Budget that legislation would be introduced to align the tax treatment of such leases more closely with their accounting treatment. Once again, the Government's stance is that if profit is booked in a particular period, it should also be taxed in that period.

The relevant provisions are now set out in CTA 2010, Pt 21 Ch 3 and apply, in principle, to any finance lease which does not fall within Chapter 2 and is entered into on or after 26 November 1996.

Where a lease falls within Chapter 3, the regime set out in Chapter 2 and described at 30 above (*except* for the aspects relating to capital allowances) then applies. Once again, therefore, the basic rule is that the lessor is to be treated for tax purposes as if he had been entitled to rent of an amount equal to the gross return (for accounting purposes) on the investment in the lease for a particular period, rather than the rent actually due under the lease (where the former is greater than the latter). Other provisions in Chapter 2 are then intended to ensure that the same income is not taxed twice. The overall result should, therefore, be that negative depreciation in the early years of the lease will be taxed but, when that negative depreciation later unwinds, tax relief will be given to ensure that there is ultimately no double taxation.

32. CROSS-BORDER AND FOREIGN CURRENCY ASPECTS

The position in relation to assets leased to non-residents and the effect of the FA 2006 reforms have already been referred to.

As far as UK withholding tax is concerned, this will generally arise only where lease rentals are paid to non-resident lessors in respect of industrial buildings or fixed plant. The usual real property withholding tax regime will then apply (see the Taxation of Income from Land (Non-residents) Regulations 1995 (SI 1995 No 2902)).

If a foreign currency purchase price is paid by a lessor for assets qualifying for capital allowances, the cost will be converted into sterling at the spot rate of exchange prevailing on the date the expenditure is, or is deemed to be, incurred. This will then establish a fixed sterling basis for writing-down allowance purposes. However, leasing in a foreign currency is not usually an attractive proposition. Exchange rate fluctuations mean that the sterling value of rental income received may well exceed the sterling value of the corresponding capital allowance (converted into sterling at the exchange rate prevailing at the outset) and interest deductions (involving the translation of amounts accrued in respect of interest into sterling pursuant to the corporate debt legislation in CTA 2009, Part 5). It will usually be better to tackle foreign currency aspects at the lessee end. Because of the various possible complications, detailed advice should always be taken.

33. THE LESSEE'S POSITION – DEDUCTIBILITY OF RENTALS

If leasing is to be an effective form of financing, it is obviously critical that the rental payments made by the lessee are deductible for tax purposes. In principle, the rentals will indeed be deductible, because they will be revenue payments wholly and exclusively laid out for the purposes of the lessee's trade. As a technical matter, this will most obviously be the case when rents are paid over the whole of the predicted economic life of the asset concerned. Nevertheless, HMRC have not generally sought to disallow part of the rental payments when the rental period has been shorter than that. In the past, moreover, as a matter of timing, HMRC allowed finance lease rentals as tax deductions over the period for which they were expressed to be payable in the lease (generally the primary period), even though a substantial proportion of the useful life of the asset would be enjoyed later on (during the secondary period). However, this practice was radically changed as a result of the issue in April 1991 of a Statement of Practice on finance lease rental payments (SP 3/91).

SP 3/91 applies only to finance leases (and, it seems, to leases treated as such under FRS5) and only to lessees (it does not apply to the receipt of rentals by the lessor). The principal difficulty with the Statement of Practice is that its basic approach is to relate the timing of tax deductions for rental payments more closely to the way in which lessees account for finance leases. It is inevitable that this cannot be a straightforward approach to the matter, because (as already mentioned) under SSAP 21 lessees are required to treat finance leases as loans funding the acquisition of the relevant asset. For accounting purposes, therefore, the rentals comprise an interest (or finance charge) element and a capital repayment element. Although the capital repayment element of the rentals does not go through the profit and loss account, HMRC accept that, for tax purposes, rental payments are entirely revenue payments for the use of the asset (so that, over time, full tax relief should in principle be given). However, where the lessee has accounted for the lease in accordance with SSAP 21, it is now necessary for rentals to be separated into the finance charge element and the capital element. HMRC will generally accept that the finance charge element is deductible as and when debited to the profit and loss account (in other words, over the primary lease period). However, the capital element should be spread over the life of the asset and will be deductible in accordance with the depreciation charged to the profit and loss account in each period (at least where that depreciation is calculated in accordance with normal commercial accounting principles). It follows that where the useful life of

the asset is significantly longer than the primary lease period, tax relief is likely to be deferred. A more surprising consequence is that there will be an acceleration of relief where the primary period is as long as the useful life of the asset and the lease provides for level rental payments (because the finance charge element will, like mortgage interest, be at its highest in the first year and will decrease over the primary lease period).

Following the introduction of SP 3/91, there was an element of doubt about the justification, in law, for the approach adopted by HMRC (in particular, their reliance on the accounting treatment), and this was highlighted by the decision of the High Court in *Gallagher v Jones [1993] STC 199*. This case was concerned with a lease of equipment under which the rental payments provided for by the lease documentation were front-end loaded: not only was there just a two year primary period followed by a twenty-one year secondary period with a nominal rent, but the primary period rent was itself loaded towards the accounting period of the lessee in which the lease commenced. It was this latter feature which provoked a Revenue challenge when the taxpayers claimed relief in respect of their entire outlay in the first accounting period. The High Court held that the taxpayers were entitled to relief for the relevant expenditure in the period in which it fell due and was incurred, even though that expenditure was incurred so as to secure a future benefit (future use of the asset) and proper principles of commercial accounting would have spread the expenditure over subsequent years so as to give a more balanced view of the nature of the success or failure of the lessee's trade. Concerned about the potentially far-reaching impact of this decision (not only upon lease rental deductions), the Revenue managed to arrange an expedited appeal against it (*[1993] STC 537*). The Court of Appeal reversed the High Court decision, holding that, subject only to any express or implied statutory rule (of which there was none in the present case), the correct way to ascertain the profits or losses of a business for tax purposes was to apply generally accepted principles of commercial accountancy, which in this case included the principles embodied in SSAP 21. Accordingly, the heavy outlay by the lessee in the accounting period in which the lease commenced was not wholly deductible for tax purposes in that period. To have allowed tax relief for all the rental payments which fell due in the relevant period would have been to give tax relief on the basis of accounts (i.e. the taxpayers' own accounts) which gave a completely misleading picture of the taxpayers' trading results. In the context of lease rental deductions, the upshot was therefore that, after a period of some doubt, the basic approach adopted in SP 3/91 was not undermined by the *Gallagher* case, and SP 3/91 survived without the need for any change in the law.

As already indicated, however, the reliance which SP 3/91 places on the accounting treatment has always seemed likely to cause problems in practice and it has, in some areas, had far-reaching implications. One difficult issue has been how to deal with non-depreciating assets. Where no depreciation is charged in the lessee's accounts (a real possibility in the case of leases of industrial and commercial buildings in enterprise zones, discussed generally at 38 below), the effect of SP 3/91 has appeared to be that no tax relief whatsoever would be available in respect of the capital element of rental payments. In essence, this has been confirmed by HMRC in a wide-ranging discussion of SP 3/91 in their February 1995 Tax Bulletin. It seems that HMRC will allow tax relief for the non-finance charge element in lease rentals in respect of non-depreciating assets only where the asset is prevented from being depreciated in the accounts by regulatory requirements *and* it is recognised that the asset does lose value over time. It follows that finance leasing of many buildings and of other non-depreciating assets is probably now uneconomical, bearing in mind that the lessor remains liable to tax on the whole of each rental payment.

HMRC's treatment of non-depreciating assets reflects the general approach which is summarised in the Tax Bulletin (see, in particular, sections 3 and 5). They state that where a rental rebate is likely to be payable at the end of the lease term (returning to the lessee substantially the entire value of the asset at that time), this should be taken into account in computing, at the inception of the lease, the total rentals to be allocated to each period of account in accordance with SP 3/91. (Rental rebates are discussed at 35 below.) Thus the aggregate tax relief for rentals (excluding the finance charge element) should reflect the estimated reduction in the value of the asset over the expected term of the lease or (if shorter) the expected useful life of the asset. In the case of non-depreciating

assets, HMRC say that the prospective rental rebate will not be less than the non-finance charge element of the rentals, so that the finance charge element alone should be deductible over the lease period.

The Tax Bulletin has, however, been helpful in providing clarification of the treatment of construction period rentals (another of the original causes for concern presented by SP 3/91). Where there is a lengthy construction period prior to the equipment becoming operational, it is common for the lessee to pay to the lessor rentals which comprise only an 'interest' element. In these circumstances, the lessee might well debit its profit and loss account in the year of payment with the entire rental paid (although it might, alternatively, capitalise the rental and add it to the cost of the asset to be depreciated over time). The concern here was that HMRC have continually emphasised that finance lease rentals are payments for the use of the relevant asset to be spread over its economic life, so that it appeared that tax relief might not be given for the period before the equipment became operational and the lease itself commenced. HMRC have, however, confirmed in the Tax Bulletin that they will allow tax relief for such construction period ('interest-only') rentals as and when paid where they are properly charged against commercial profits in the period in which they are incurred. On the other hand, this treatment will not be available where construction period rentals are capitalised.

Reference should also be made to the February 1995 Tax Bulletin for HMRC's views on a number of other issues not specifically addressed in SP 3/91 itself – for example, the treatment of sale and lease-back transactions, changes in depreciation policy during the term of the lease and multiple asset leases. Finance leases of fixtures under CAA 2001, s 177 (so-called 'deemed leases') and – especially – the termination of such leases, raise particular issues for the lessee (see section 8 of the Tax Bulletin) and specialist advice should always be taken.

Rather oddly, the lease or buy decision may now have swung in favour of lease when one is dealing with long-life assets. If the accounting depreciation life of an asset is relatively short (at least for the bulk of the cost), lessee deductions for the capital element of rental payments may, following SP 3/91, actually exceed the capital allowances that would have been available on an outright purchase.

The deductibility of rentals under long funding leases is of course governed by the statutory rules now set out in CTA 2010, ss 377-380: see 12 above. However, as previously explained, lessees may in effect elect for rental deductions to remain governed by the traditional regime (although, not surprisingly, they will then have no entitlement to capital allowances in respect of the leased asset).

34. SALES AID LEASING AND RESIDUAL VALUE SUPPORT

Specific advice should always be sought where sales aid leasing involves options for the manufacturer or vendor to acquire the leased asset. Such arrangements may, but will not always, detract from the lessor's ownership of the asset for capital allowance purposes. Also a sale at less than market value may, depending on the circumstances, result in a higher deemed sales price for balancing charge purposes (CAA 2001, s 61(2)(4)). The silly point here is that a low value sale back to the manufacturer will result in a higher taxable profit to the manufacturer on re-sale. The capital allowance rules do not recognise this, however, and still provide for the seller's sale price to be increased to market value (so that there is an element of double taxation).

Residual value insurance or other support is another area of growing interest where advice should be taken. HMRC's position is understood to be that fees or premiums for such cover are non-deductible on the grounds that they are capital in nature. This must be open to question where such payments are recurrent and secure cover on a periodical basis only. Otherwise, all factory insurance cover would be non-deductible. Insurance or other proceeds

are likely to be treated as part of the disposal proceeds for balancing charge purposes (CAA 2001, s 61(2)). If undepreciated expenditure is still left in the pool, this treatment should be advantageous.

35. TERMINATION OF TRADITIONAL FINANCE LEASES

The financial consequences of termination will depend on when termination takes place. If the lessor has already then received sufficient rentals to retire its investment, recover its financing costs and earn its agreed return, sale proceeds will accrue almost entirely for the lessee's benefit. If, on the other hand, the lessor has not been fully paid out, a lump sum terminal rental may be required. This may or may not be required to be paid before sale or disposal proceeds have been received and so may or may not take them into account. In the former case, the proceeds will be received and retained by the lessor and the terminal rental will be correspondingly reduced. In the latter case, the sale or disposal proceeds will have to be rebated to the lessee when they are eventually received.

If the lessor sells the asset at the end of the lease or an insured loss occurs, the lessor may suffer a balancing charge as a result of the receipt of the net proceeds of sale or insurance. Any proportion of the sale or insurance proceeds which is allowed to the lessee by way of rebate of rentals should, however, be treated as deductible in the lessor's hands, thereby offsetting the balancing charge. It is customary for the lessor to take an indemnity from the lessee against any adverse tax consequences of the rebate arrangement, particularly if the lessor is under commercial pressure from the lessee to rebate virtually the entire sale proceeds of the asset. A lessee who has given such an indemnity will try to arrange matters so that the likelihood of a rebate is minimised by deferring the payment of terminal rentals until sale or insurance proceeds have been received.

It is also now important to note that, by virtue of CTA 2009, s 60A (introduced by FA 2010), the amount of tax relief allowable in respect of a rental rebate by a lessor is limited to the aggregate amount of the lessor's income from the lease (reduced, in the case of a finance lease, by the finance charge element). For this purpose, the lessor's income from the lease is the aggregate of all amounts receivable in connection with the lease that have been brought into account as income for tax purposes (but excluding any disposal receipts for capital allowances purposes). This change in the law, which has effect in relation to rental rebates payable on or after 9 December 2009, illustrates why it will have been important for lessors to obtain the sort of indemnification referred to above in respect of the tax treatment of any rental rebate arrangement.

The possible advantages within the pool system of a termination and the receipt of sale or insurance proceeds matched by a fully deductible rebate have already been pointed out at 20 above. Where an asset is sold for more than its tax written-down value, the excess can of course be set off in full against *other* available qualifying expenditure within the pool. This can be a great advantage to the lessor, as it serves to accelerate allowances on other transactions. If, however, the rate of corporation tax increases in subsequent periods, any advantage may be outweighed by the fact that the allowances would have had a higher tax value in the later periods. It is worth bearing in mind also that a sale of the asset for more than its original cost is capable of producing some quite considerable benefits for the lessor. This is because the excess of sale proceeds over original cost is not debited to the pool but is a receipt only for capital gains purposes; and by virtue of the indexation allowance, part of that receipt is likely to be tax free. Yet the corresponding rebate of rentals will be deductible as a revenue expense (albeit subject to the limitation in the new CTA 2009, s 60A).

As far as the lessee is concerned, the tax treatment of rental rebates has been affected by SP 3/91 (discussed at 33 above). On an early termination of a lease, a lessee might well (by virtue of SP 3/91) find itself having paid out rentals for which tax relief has not yet been received. In these circumstances, it would appear that any rebate of rentals (out of sale proceeds) will be tax-free in the lessee's hands to the extent of any rentals paid prior to

termination for which no tax relief has been obtained. Subject to that, rental rebates will continue to be taxable as income in the hands of the lessee, and where a lessee has obtained tax relief in excess of rentals paid under the lease prior to termination, it seems that an amount equal to the excess will be treated as further taxable income (in effect, there will – at termination – be a recapture of the earlier relief). For a detailed discussion of HMRC's views on the tax treatment of termination adjustments in the hands of the lessee, reference should be made to section 7 and (in the case of fixtures leases) section 8 of the article on SP 3/91 in the Tax Bulletin February 1995 (although the authority for some of their comments on the termination of 'deemed leases' of fixtures is by no means clear).

The following points should also be noted.

(i) The lessor should not grant the lessee an option to acquire the plant or machinery from the lessor at the end of the lease. If it does so, the effect of CAA 2001, s 67 may be that the right to claim capital allowances will accrue to the lessee or, at the least, that the lessor's right to claim allowances will be lost as the asset may have ceased to be owned by the lessor. In this context, it is immaterial whether the lessee is UK resident or outside the UK tax net (FA 2006, Sch 9, para 12(2)). However, it seems to be accepted that there is no objection to the familiar provision whereby the lessee is given a right to sell the equipment on behalf of the lessor at the end of the lease. It is prudent for the lessee to be required to obtain the lessor's prior consent to any sale and for it not to be allowed to sell to itself or to any associate.

(ii) While it is perfectly acceptable in some cases for the sale of the equipment to the lessee on arm's length terms to be negotiated at the end of the lease, the lessor should not undertake any prior commitment to do this. Otherwise the requisite degree of ownership may be lost and with it the right to capital allowances. Some lessors refuse to sell to lessees as a matter of principle. Fixtures leasing may be advantageous in this respect since title may revert as a matter of law if the lessee owns the freehold or a superior leasehold interest. Deemed leasing of fixtures under CAA 2001, s 177 also involves no such problems since the lessor never acquires legal ownership in the first place.

36. VALUE ADDED TAX

Leasing is treated as a supply of services rather than a supply of goods. The lessor will usually charge VAT on the lease rentals at the standard rate (having itself paid VAT at the standard rate on the purchase of the equipment) unless the supply is zero-rated or is outside the scope of UK VAT (the latter being the treatment generally applicable to leases of assets to overseas lessees as from 1 January 1993). The supply of certain aircraft and ships is zero-rated and, following a helpful change announced in the March 1993 Budget, zero-rating was extended to supplies of parts and equipment for use in such aircraft or ships. The usual rules relating to the recovery of input tax apply, so that in general the input and output VAT will be fully off-settable and excess inputs will be recoverable (and input tax will also be recoverable in those cases where the supply by the lessor is now outside the scope of UK VAT). Similarly, most lessees will be able to recover in full any VAT paid on the rentals.

The payment of VAT on the original supply gives rise to a cash flow cost for the lessor. It may be several months before the benefit of the input credit is obtained. The receipt of VAT on rentals gives rise to a corresponding benefit over time. On that basis, most leases do not seek to make any adjustment on account of delays in obtaining credits or paying over output tax received. It is, however, prudent for lessors to take an indemnity against failing to get credit for VAT paid.

By virtue of the rules governing the determination of the tax point for the purposes of leasing, leasing is treated as a series of supplies each of which is made when a rental payment is received or when a tax invoice is issued,

whichever is the earlier. However, the lessor may issue tax invoices annually (in advance) which set out the date and amount of each payment and the rate and amount of VAT chargeable. If the lessor follows this procedure the supply will be treated as taking place on the earlier of the due date of the rental payment and the date of the receipt (Value Added Tax Regulations 1995 (SI 1995 No 2518), reg 90).

Complicated VAT points arise where any element of fixtures leasing is involved and specialist advice should be taken. In the past, the supply of fixed plant or machinery constituted an exempt supply and therefore affected the lessor's ability to recover VAT paid. It was therefore necessary for lessors to try to ensure that the acquisition of the assets concerned was made in such a way as to avoid the payment of VAT. It was also necessary to ensure that fixtures leasing did not prejudice other standard-rated activities of the lessor. However, the effect of the changes related to land in the Finance Act 1989 has, in general, been to simplify matters for the equipment lessor. Most land-related transactions have become standard-rated (rather than exempt) so that there are generally no recovery problems.

Furthermore, HMRC in general appear to be prepared to treat 'deemed leases' under CAA 2001, s 177 as qualifying for standard-rated treatment, so that any VAT paid on the acquisition of the relevant plant or machinery and any related inputs will be fully recoverable. Care should, however, be taken where the transaction is structured in such a way that the equipment lessor does not at any stage acquire an interest in the asset concerned, as this may call into question whether the lessor has truly made a standard-rated supply of equipment or has entered into a financial transaction constituting an exempt supply. In these circumstances, specialist advice should always be sought.

Advice should also be taken on the VAT implications of rebating rentals (in relation to which there is an agreed joint statement of practice issued by Customs & Excise and the Equipment Leasing Association on 1 January 1984) and of hire purchase or conditional sale transactions (where special rules apply).

37. STAMP DUTY/STAMP DUTY LAND TAX

Stamp duty land tax will be an issue where fixed plant or machinery is concerned and it will be difficult to avoid (except on 'deemed leases' involving no land interest). With unfixed plant or machinery, there will be no duty on the lease itself or on the transfer of the asset (which will, in any event, usually be by delivery). Specialist advice should be taken in relation to the stamp duty land tax implications of the acquisition and leasing of fixed plant or machinery.

38. INDUSTRIAL BUILDINGS AND ENTERPRISE ZONES

The leasing of industrial buildings or structures is a specialised form of finance leasing on which detailed advice should always be taken. Subject to what is said below, the economics of an industrial building finance lease are much the same as for an equipment finance lease, so most of the points in this article will be equally relevant to these transactions as well (and the FA 2006 reforms, which relate only to plant or machinery leases, will not be in point).

Substantial allowances are now available only if the building is in an enterprise zone. Allowances may then also be available on certain hotels or commercial buildings or structures. An initial allowance is available in respect of qualifying expenditure in an enterprise zone at the rate of 100% (CAA 2001, ss 305, 306). Helpfully, by virtue of CAA 2001, s 301, a person buying a building in an enterprise zone will be able to claim a 100% initial allowance

if the purchase takes place within two years of the building being brought into use (whereas, prior to 1992, the building had to be unused).

Specialist advice should always be taken in relation to the termination of enterprise zone leases. Prior to the Finance Act 1994, a lessor would often be able to avoid suffering a balancing charge on termination by ensuring that, rather than transferring its interest in the building, it granted a long lease (or some other subordinate interest) instead. However, the circumstances in which this will be feasible in the future have been significantly restricted as a result of the provisions now included in CAA 2001, ss 327 to 331 (although this restriction does not apply to industrial buildings outside enterprise zones).

As mentioned above, the economic viability of the finance leasing of non-depreciating assets has been seriously affected by HMRC's view that, in general, only the finance charge element in rentals should be deductible over the lease period in the lessee's hands. This problem is obviously of particular relevance in the case of industrial and commercial buildings.

It was announced in the March 2007 Budget that writing-down allowances on ordinary industrial buildings would be gradually phased out from 2008/09, with full withdrawal taking effect from April 2011. Subsequently, the Government decided that the ultimate abolition of allowances on industrial buildings should be extended to buildings in enterprise zones. Accordingly, FA 2008, s 84 provides that expenditure incurred on or after 1 April 2011 will not qualify for any industrial buildings allowance or enterprise zone allowance.

The gradual phasing out of ordinary writing-down allowances on expenditure on industrial buildings over the period from 2008 to 2011 is provided for by FA 2008, s 85 and does not apply to qualifying enterprise zone expenditure (in respect of which 100% initial allowances remain available for the time being).

Whilst expenditure incurred on or after 1 April 2011 will not be eligible for enterprise zone allowances, it is made clear by FA 2008, Sch 27, para 31 that balancing charges may still be triggered after that date (for example, on the sale of the relevant interest in the building in the enterprise zone) unless the balancing event in question occurs more than seven years after the building was first used.

39. TRADITIONAL LEASE DOCUMENTATION – SPECIAL TAX POINTS

A brief summary of the points that need to be covered is as follows:

(i) obligation on lessee to provide information to lessor and HMRC to assist claim for allowances;

(ii) obligation on lessor to claim allowances and act generally in accordance with standards observed in equipment leasing industry (i.e. play fair by lessee in settling tax disputes);

(iii) warranty on cost/market value for sale/leaseback;

(iv) interest adjustment provisions may need modification if rent changes, depending on precise formula used;

(v) tax adjustment provisions which will need:

  (a) to specify what factors (timing of expenditure, rate of allowance, lease not a long funding lease, rate of tax, tax payment delay, assumed grant and delay in receiving, assumed funding cost, lessor's rate

of return and reinvestment rate on surplus cash balances, assumption on residual value to sweep up residual writing-down allowances, accruals or cash basis for interest and rent) have been taken into account in determining rent or to give the lessor absolute power to adjust in its own discretion. Referral to an expert will be desirable, in the latter case with an obligation for the lessor to provide rental and adjustment calculation details to the expert;

(b) to specify how adjustments are to be calculated – lump sum, retrospective or spread forward; and

(c) to cover retrospective tax changes.

For a judicial decision involving a dispute over the operation of certain tax adjustment provisions, see *Gold Fields Mining and Industrial Ltd v GKN (UK) plc [1996] STC 173*;

(vi) terminal rental provisions – may need modification if rent changes, depending on formula used. May also have to be adjusted retrospectively for tax changes;

(vii) provision for compensation/adjustment on unutilised capacity allocated to this deal or surplus allowances arising as a result of expenditure not being incurred when anticipated or rate of allowances changing;

(viii) grossing-up of rentals for withholding tax;

(ix) indemnity on irrecoverability of VAT;

(x) indemnity on non-deductibility of rebates (and now see CTA 2009, s 60A); and

(xi) general tax indemnity on taxes (including stamp duty land tax) arising as a result of ownership of asset (other than corporation tax on rental income) or on indemnity or reimbursement payments under lease.

40. RAMSAY AND THE DISCLOSURE REGIME

It is clear that *W T Ramsay Ltd v IRC [1981] STC 174* and *Furniss v Dawson 55 TC 324* have had the same impact on the more exotic leasing structures that they have had in other areas. Purely tax motivated sale/leasebacks where the funds raised are, in large part, deposited to secure rental payments were an early casualty, and film leasing and non-recourse or back to back deals have, as already mentioned, come under close HMRC scrutiny (see *Ensign Tankers (Leasing) Ltd v Stokes 64 TC 617*, referred to at 15 above).

As a technical matter, the *Ramsay* and *Furniss v Dawson* principles do not apply to so-called single step transactions, such as a straightforward finance lease as compared with a straightforward loan, credit sale or hire purchase agreement. Composite transactions (including most finance leasing transactions where there will be the successive steps of the raising of finance by the lessor, the purchase of the asset and its leasing to the lessee) will generally be at risk only if (a) they are entirely circular or self-cancelling so that the parties have returned to the commercial position they were in at the outset, or (b) steps have been inserted which are purely tax motivated and have no business purpose. The vast bulk of leasing transactions will fall into neither category (and recent judicial decisions demonstrate that HMRC will not always be able to challenge a transaction that does fall into one of those categories: see further below).

The Institute of Chartered Accountants' letter to the Revenue of July 1985 concerning *Furniss v Dawson* raised the question of the application of the 'new approach' to leasing transactions. The Revenue's response was predictable: straightforward commercial leasing transactions (especially those involving hire and operating leasing) are unlikely to be challenged, but complicated leasing arrangements may well be subject to Revenue scrutiny. The specific reference to hire and operating leasing is somewhat disconcerting, because it seems to imply that finance leasing may fall to be treated differently. The Revenue suggested that the *Furniss v Dawson* principle may apply to transactions having one (or more) of a number of specified ingredients. These include:

(a) non-recourse finance so that the lessor is not at risk or there may be doubt about whether the lessor 'has actually incurred the capital expenditure concerned';

(b) a lack of profitability (whether pre – or post – tax is not specified);

(c) lessee funding so that there may be doubt about whether or not the lessor has genuinely financed the transaction;

(d) doubt whether 'expenditure has been incurred for the purposes of the claimant's trade'; or

(e) artificial structuring of a composite transaction 'so as to bring it within the provisions, about claiming allowances, of the Finance Acts'.

Whilst it is easy to see that the first three of these could produce a situation where the transaction was circular or self-cancelling and that artificial structuring (i.e. (e)) may well involve the insertion of a tax-motivated step, it is very difficult to see how doubt as to 'whether expenditure has been incurred for the purposes of the claimant's trade' can be in any way relevant to the principles behind *Ramsay* and *Furniss v Dawson*.

Nevertheless, in circumstances where one or more of these ingredients may be present, or where there is some other cause for concern that the *Ramsay* and *Furniss v Dawson* principles may be applicable, reference should be made to the subsequent judicial authorities in this area – including the House of Lords decisions in *MacNiven v Westmoreland Investments Ltd [2001] STC 237*, *IRC v Scottish Provident Institution [2004] UKHL 52, [2005] STC 15* and *Barclays Mercantile Business Finance v Mawson [2004] UKHL 51, [2005] STC 1*.

The decision of the High Court in *Barclays Mercantile Business Finance v Mawson [2002] EWHC 1527 (Ch), [2002] STC 1068* involved an unconvincing application of the *Westmoreland* case in the context of an equipment sale and lease-back transaction incorporating what *appear* to have been intricate defeasance arrangements.

This case concerned a lease of a gas pipeline granted by BMBF, a leasing subsidiary of Barclays, to the Irish Gas Board (BGE), the subsequent sub-lease of the pipeline by BGE to one of its wholly-owned UK resident subsidiaries, BGE (UK), and the related security and financing arrangements. The pipeline in question, which was owned at the outset by BGE, was sold by BGE to BMBF for a lump sum and then leased back to BGE by way of a head lease before, in turn, being sub-leased by BGE to BGE (UK). BGE (UK) then entered into a 'take or pay' contract with BGE under which BGE (UK) agreed to supply gas to BGE through the pipeline in return for certain payments, the quantum of which, irrespective of BGE's actual usage of the pipeline, would be sufficient to enable BGE (UK) to discharge its sub-lease obligations. At the same time, BGE, BGE (UK) and BMBF entered into a so-called assumption agreement under which it was agreed that BGE (UK) would make its sub-lease rental payments directly to BMBF to the extent that they did not exceed BGE's head lease rental payments to BMBF and that this would serve to discharge both BGE (UK)'s obligations under the sub-lease and BGE's obligations under the head lease by an equivalent amount.

BMBF financed itself by way of loan from Barclays and Barclays also guaranteed the obligations of BGE (UK) under the assumption agreement. Barclays' obligations under that guarantee were collateralised by a deposit of an amount equal to the initial sales proceeds received by BGE with Barclays through an intermediate Jersey company owned by a charitable trust. In essence, the funding provided by Barclays to BMBF passed from BMBF to BGE, from BGE to the Jersey company and from the Jersey company to Barclays. Ongoing interest and principal payments made by Barclays to the Jersey company and, thence, to BGE financed the payments by BGE under the 'take or pay' contract and the payments by BGE (UK) under the assumption agreement.

Applying the *Westmoreland* decision, the High Court held that the lessor (BMBF) was not entitled to capital allowances because, in reality, its expenditure was incurred on the right to cash flows under a complex set of agreements (including the lease documents) rather than on the pipeline itself (notwithstanding that, as a matter of law, the lessor did acquire title to the pipeline). Whilst it must be acknowledged that aspects of the transaction in question were somewhat out of the ordinary (see, for example, the way in which the parties agreed to share the benefit of the anticipated allowances, as well as the defeasance arrangements), the conclusion that the lessor incurred its expenditure on the right to money flows appeared to confuse the financial consequences of a leasing transaction with the tangible asset acquired by virtue of the lessor's initial cash payment (that tangible asset then becoming the subject of the leasing transaction and thus generating the payment flows). Most importantly, the High Court decision left it far from clear where the line was to be drawn between cases where the expenditure could be said for tax purposes to have been incurred on the provision of the relevant plant or machinery and other cases where the expenditure must be held in reality to have been incurred on acquiring only the right to payment flows. In the light of Park J's decision, outright defeasance payments (of the sums raised by the sale and lease-back) by a lessee back into the lessor's group would clearly be vulnerable in terms of the lessor's entitlement to allowances. However, this probably needed to be contrasted with the situation in which the lessee had an entitlement to withdraw the relevant deposit and provide alternative collateral. It should also be noted that Park J held, as a separate matter, that the lessor's expenditure had not been incurred wholly and exclusively for the purposes of its trade (on the basis that, in his view, the transaction in question stood apart from the generality of the lessor's finance leasing transactions to such a great extent). The unsatisfactory point on this aspect was that Park J did not explain how the lessor was to be taxed on the rentals if the lease was not a trading transaction.

In the light of these significant difficulties, the decisions of the Court of Appeal and the House of Lords in favour of BMBF have been particularly welcome. Much had been made, in the High Court decision, of the fact that BGE could never get its hands on the sale proceeds of the equipment, but was instead required to deposit those proceeds with Barclays (albeit via the Jersey company). However, the House of Lords held that, in applying any statutory provision, it is necessary first to decide, on a purposive construction, exactly what transaction will answer to the statutory description and, secondly, to decide whether the transaction under scrutiny does so (when viewed realistically). It is therefore critical to identify the requirements of a particular statutory provision before it can be decided whether circular payments or steps inserted for the purpose of tax avoidance should be disregarded.

The statutory requirements in what is now CAA 2001, s 11 are in the case of a finance lease concerned entirely with the acts and the purposes of the lessor. The legislation is not concerned with what the seller/lessee does with the sale price, how it should find the money to pay the rent or how it should use the leased asset. From the lessor's point of view, all the statutory requirements (for allowances to be available) were satisfied: BMBF's expenditure had been incurred on the provision of the pipeline and wholly and exclusively for the purpose of its ordinary finance leasing trade (there was unchallenged evidence on this latter point). According to the House of Lords, it was irrelevant to the lessor's tax treatment that the lessee chose to make arrangements which resulted in the bulk of the sale price being committed to paying the rent and, in particular, that Barclays Bank both lent the purchase monies to the lessor and happened to be the bank which provided the cash collateralised guarantee to BMBF for the payment of the rent.

See also the recent Court of Appeal decision in *Tower MCashback LLP1 v Revenue and Customs Comrs [2010] STC 809*, which basically follows the approach taken by the House of Lords in the *Mawson* case. In *Tower MCashback*, the court did pay some regard to the terms on which the relevant assets were financed (including a limited recourse feature) but nevertheless concluded that, as the taxpayer had acquired ownership of those assets – and thus the full economic benefits of them – in return for its expenditure, it was entitled to allowances in respect of that expenditure.

Originally, equipment leases did not in themselves give rise to any statutory obligation to provide notification to HMRC pursuant to the disclosure regime introduced by Part 7 FA 2004. Under the relevant regulations, anything treated as a finance lease for the purposes of generally accepted accounting practice was specifically excluded from the ambit of this regime. However, following an announcement in the March 2006 Budget, new rules came into force on 1 August 2006. A detailed description of the disclosure regime is beyond the scope of this article but the point to note is that, within the context of the overall regime (as revised in 2006) and thus subject to its general rules, leasing arrangements will now be 'prescribed' and hence potentially subject to disclosure to HMRC if certain conditions are satisfied.

The basic position is that the arrangements must include a 'plant or machinery lease', as defined in the new regulations (The Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2006) and, in general, the lease must have a term of more than two years. Also, *either* the lower of the cost to the lessor or the market value of any one asset leased under the arrangements must be at least £10 million *or* the aggregate of the lower of the costs to the lessor or the market values of all the leased assets must be at least £25 million.

Importantly, it is then necessary that one of the so-called 'additional' conditions is also satisfied. In very broad terms, it is essential that the arrangements are designed to include a sale and finance lease-back or a lease and finance lease-back (see 26 above); *or* that there are defeasance arrangements – involving the removal from the lessor of the whole or the greater part of the risk of a loss being sustained by reason of lease payments not being made in accordance with the terms of the lease; *or* that one party is or would be entitled to plant and machinery allowances while another party (other than a mere guarantor under the lease) is or would be outside the charge to UK corporation tax. This latter condition appears to be capable of covering both traditional leases (under which the lessor is entitled to allowances) to non-resident lessees, formerly within the scope of the 'overseas leasing' code referred to in 25 above and, in addition, long funding leases within the scope of the FA 2006 leasing regime under which the lessee is entitled to allowances and the lessor is a non-resident. This illustrates that, notwithstanding the overhaul of the leasing system provided for by FA 2006, HMRC remain particularly concerned that cross-border arrangements may involve unacceptable tax planning.

41. SALE OF LEASING COMPANIES

The 'tax deferral' benefits of traditional finance leasing have been explained in 2 above. The typical profile for a lessor entitled to capital allowances is that, in the early years of a lease, the aggregate of those allowances and the lessor's finance charges will exceed rental income, so that (at least as far as this particular transaction is concerned) the lessor will be in a tax loss position. In later years, once lessor funding has been paid down and the available capital allowances have diminished, the leasing company will have taxable profits.

It appears that these basic economics encouraged groups to find ways in which to shelter the taxable profits of those leasing companies which had moved (or were about to move) into the phase when the earlier tax deferral benefits had begun (or would begin) to unwind. The most common strategy was to arrange for the leasing company to be sold to a company (or group) which was loss-making for tax purposes, so that the purchaser's

losses could be used – through the group relief system – to shelter the taxable profits of the newly acquired leasing company on a current year basis.

Provisions were therefore introduced in FA 2006 in order to render this strategy ineffective and thus ensure that the 'tax deferral' benefits accruing to leasing companies could not be turned into more permanent tax savings. These rules are now set out in CTA 2010, ss 382-437 and are drafted in such a way as to apply not just to sales of leasing companies but also to any other change in the economic ownership of a leasing business. The rules also cover other methods by which the deferred profits from leasing activities might otherwise be sheltered from tax.

A detailed consideration of the 'sale of lessors' regime is beyond the scope of this article. In brief, the change of ownership of a leasing company will bring an accounting period to an end. In respect of the period ending with the change of ownership, the company will then be treated as if it had received income calculated by reference to the amount by which the book value of the leasing company's plant or machinery (including amounts shown as the net investment in respect of finance leases) exceeds the tax written-down value of such plant or machinery. A corresponding tax deduction is then given in the accounting period beginning on the day after the change of ownership. The rationale, of course, is that the leasing company's deferred tax is effectively brought into charge immediately before the change of ownership and this tax charge cannot be sheltered by the purchasing company's losses. The corresponding deduction given in the period commencing after the change of ownership will naturally be of little interest to a purchasing group which is structurally loss-making. Needless to say, it is provided that the deduction cannot be carried back to an earlier period.

When this regime was introduced in 2006, it quite deliberately addressed the increasingly prevalent strategy of selling leasing companies to loss-making groups. However, the legislation would apply equally to a non-tax motivated sale of a leasing company to (for example) a single purchasing entity that just happened to lack the tax capacity to absorb the corresponding tax relief arising immediately after the change of ownership. In order to address this problem, FA 2010, Sch 18 has introduced provisions under which it is possible to elect out of the "sale of lessors" tax charge and, as an alternative, place the leasing business within a ring fence. The ring fence will operate so as to prohibit the reduction of the profits of the leasing business through the utilisation of losses, except to the extent that the losses are attributable to the leasing business itself. There is also a wide prohibition on claiming plant and machinery allowances on new assets, the intention being to prevent any further expansion of the ring fenced leasing business. The overall objective is, therefore, to capture a leasing company's deferred tax as the deferred profits arise rather than through the normal "sale of lessors" charge. Whether this statutory election out of the 2006 regime will prove useful to taxpayers, in the light of the ring fence restrictions, remains to be seen.

The original attack on tax-driven disposals of leasing businesses was announced in the Pre-Budget Report of December 2005. In some ways, it is surprising that action was not taken at an earlier stage. Presumably, however, the government were concerned that the general overhaul of the leasing system introduced by FA 2006 and described earlier in this article might well push many leasing companies into a tax paying position (with limited scope to obtain future capital allowances) and thus encourage their owners to sell such companies to loss-making groups.

42. THE FUTURE

Against the background of the fundamental reforms introduced by FA 2006, the following observations may be made about the future of equipment leasing in the UK.

(a) Traditional tax-based finance leasing of large assets – where the lessor obtains capital allowances and passes some of the benefit through to the lessee – will in general no longer be feasible. The main exceptions to this are leases of certain ships to tonnage tax companies (which are likely to remain an active market) and leases grandfathered under the FA 2006 transitional rules.

(b) Much operating leasing will remain viable from a tax perspective – but, of course, this will not apply to those operating leases which are essentially financing transactions and thus potentially within the scope of the FA 2006 reforms.

(c) In addition, however, there may be some interest in leasing which is subject to the FA 2006 regime (i.e. being a long funding lease) but may nevertheless be accounted for by the lessee as an operating lease. The potential attraction for the lessee is that such leasing will be 'off balance sheet' as an accounting matter.

(d) In the early days of the new FA 2006 regime, there has inevitably been considerable focus on the rather complex grandfathering provisions described in detail in 10 above.

(e) There may in the future be some interest in arrangements under which a UK lessor finances its own acquisition of the relevant asset through a long funding lease from a legal owner resident overseas, thus potentially (and depending on the overall circumstances) enabling the UK lessor to claim capital allowances pursuant to the new FA 2006 regime while enabling the overseas owner to claim tax depreciation in its own jurisdiction. Any opportunities in this area will of course be subject, in particular, to CAA 2001, s 70V where the asset is sub-leased to a non-resident.

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