Taxation of leased assets: the new HMRC discussion document

The new accounting standard, *IFRS 16 Leases* (IFRS 16), will be effective from 1 January 2019 for many large UK companies which adopt International Financial Reporting Standards. For lessees, the effect of this new accounting standard is that the concept of an "operating" lease will no longer exist. Instead lessees will be required to record each contract defined as a lease under IFRS 16, as a financial liability and a right of use asset (there are exceptions from this rule (i) for leases of 12 months or less and (ii) for low value assets which the International Accounting Standards Board (IASB) suggests are those under a threshold of $5,000).

For tax purposes, section 53 Finance Act 2011 deems lease accounting changes occurring on or after 1 January 2011 not to have effect. Absent any other law changes, when IFRS 16 comes into force this tax provision will apply. It is however generally recognised that it does not provide a satisfactory long-term solution. It requires affected companies to maintain two separate sets of accounting records. This could be onerous as it will not merely be a matter of retaining "finance lease" and "operating lease" labels for leased assets but also will necessitate different recognition of lease rental income and expense.

Hence it is good news that HMRC is grasping the nettle of a necessary change in time for the arrival of IFRS 16. In this article we reflect on some of the key questions. This is an early stage and we recognise all the design features of a new regime are not yet present in the proposals HMRC have outlined.

What are the problems if nothing is done?

Under new IFRS 16, the familiar distinction between a "finance lease" and an "operating lease" will cease to apply for most lessees. As a result many aspects of the UK tax rules will fail to apply as intended. For example:

- The long funding lease tests, which rely heavily on the accounting classification of leases;
- Section 67 CAA 2001, which applies differently to finance leases;
- Rules on finance leasebacks e.g. sections 70I(9), 70I(10) and 219 CAA 2001; and
- Anti-avoidance legislation such as the Type 1 arrangement rules.

What options are HMRC putting forward?

HMRC explain that they seek to make changes recognising the changing commercial environment (the shrinkage of the tax-driven leasing industry). They favour simplicity if possible but also want strong revenue protection.

Summary of HMRC proposals for taxation of leased plant & machinery		
Option 1	Retain current tax rules with changes necessary (to deal with loss of operating lease / finance lease concept)	
Option 2	Base tax on the accounts income statement with only minor adjustments to prevent abuses	With no further tax adjustments or incentives
Option 3		With an optional "lease allowance" (accelerated depreciation) on the right of use asset
Option 4		With optional capital allowances on the right of use asset

1) **Option 1:** *"Where it's broke, fix it"*

HMRC's **Option 1** is the current tax system with "necessary adaptations which maintain the effect of the current rules". We anticipate these changes will involve replacing current references to finance and operating leases with alternative definitions.

Under this option, capital allowances would remain available to lessors and the long funding lease rules would continue to transfer capital allowances entitlement to some lessees.

2) **Options 2 - 4:** "*Follow the accounts"*

HMRC also present three other related options which all align the tax treatment of leased assets more closely with the accounting entries. HMRC consider anti-avoidance measures will be required in some areas. Asymmetry between lessor and lessee treatment is one example they identify. Another is "acceptable rates of depreciation". We can therefore expect targeted anti-avoidance rules (TAARs) as part of Options 2, 3 or 4.

An element of tax incentive may be retained through one or other of two variants of Option 2:

Option 3 involves the option of a "lease allowance" – in essence accelerated depreciation of the right of use asset.

Option 4 gives the lessee an option to claim capital allowances on the right of use asset in place of accounting depreciation.

What changes to the existing system will Option 1 involve?

HMRC have not indicated what the changes will be. They believe that the changes can be achieved without significant extra complexity. In the absence of detailed proposals it is hard to comment.

A decision will be needed on whether the rules applying currently to finance leases should in future apply to lessees under all leases which have a financial liability. This decision will need to reflect the fact that companies using current UK GAAP i.e. FRS 102 (except those applying FRS 101) will continue to apply lease accounting as specified under the current IAS 17.

As a policy matter there will thus need to be a decision - which may not be straightforward - on whether to extend the scope of some of our anti-avoidance measures or to abandon them. It is possible that we could see a "tax finance lease" concept based on non-accounting tests, rather as the long funding lease regime introduced the concept of a "long funding operating lease" based on tax tests as an adjunct to the long funding finance lease (which was more grounded in the accounts treatment).

How will the accounts basis for taxation work?

If an accounts based option is adopted, the lessor will be taxed on their income statement finance income and will receive no capital allowances. Profit or loss on sale and rental rebates will also be taxable/deductible.

A lessee applying IFRS 16 will claim a tax deduction for their finance charge -which will be recognised so as to give a constant rate of return on the outstanding balance - and for the depreciation of their right of use asset, normally on a straight line basis. The lessee will be taxed on rebates received. The concept of a capital/revenue divide will be abandoned. (A UK GAAP operating lessee however will simply claim a tax deduction for the total rental going through the income statement.)

The incentives currently offered by capital allowances could potentially be preserved by giving the ultimate lessee an option to claim capital allowances on their right of use asset (Option 4), or by giving a 'leasing allowance' - essentially faster depreciation of the right of use asset for tax purposes (Option 3).

If capital allowances are available the lessee would then be able to benefit from, for example, first year allowances, the Annual Investment Allowance or short life asset elections where relevant.

HMRC give an example showing a leasing allowance of "x1.1" meaning that depreciation in early periods of the lease is actual depreciation of the right of use asset with a 10 percent uplift. Alternatively the pattern of depreciation for an asset might be on a specified reducing balanced basis.

HMRC note that under Options 3 and 4, lessees using UK GAAP would need to calculate a notional right of use asset in order to claim capital allowances or a "leasing allowance": they suggest an online calculator could be devised to enable this asset to be calculated. This seems an unattractive complexity but it should be a temporary feature for most leases if new UK GAAP (FRS 102) falls into line with IFRS at some point in the future (possibly 2022 at the earliest). Leases excluded from IFRS 16 (short term leases and low value assets) will continue to require a notional right of use calculation if they are to benefit from Option 3 or 4 incentives.

Lessors would have no capital allowances options or other incentives under Options 2, 3 or 4. The loss of capital allowances may be a concern for some operating lessors such as the rolling stock companies whose leases are typically non-long funding operating leases (the trainsets having a lifespan of 35-40 years but the leases tracking the rail franchise periods, normally 5 to 7 years).

Are all leased assets affected by these proposals?

The proposals are confined to plant and machinery. As a policy matter future governments may perhaps decide that UK infrastructure investments or expenditure on certain buildings should attract tax relief but this decision would be separate from the current proposals.

We assume that the current case law and statute definitions of plant and machinery will survive as the touchstone of what attracts a tax deduction although this remains to be confirmed.

The accounts-based proposals would therefore involve the need to make a distinction between (i) tax depreciation on qualifying plant and machinery and (ii) other depreciation which will not be tax deductible.

What is the future of capital allowances?

Options 2 and 3 would remove capital allowances in the case of leased assets. We note that the Office of Tax Simplification is also considering options for the future of capital allowances and we imagine that they may well recommend capital allowances be replaced by tax depreciation. Over the last 20 years the tax landscape has shifted dramatically as writing down allowance rates have fallen from 25 percent to 18 percent, long life assets and integral features have attracted an even lower rate of 8 percent and long funding lessors have lost their entitlement to allowances. Lower rates of allowances (and the loss of Industrial Building Allowances) have been a quid pro quo for a downward trend of UK corporation tax rates which have practically halved from 33 percent in 1996 to a forecast 17 percent - or lower? - from 2020.

HMRC refer to the effect of these and other economic trends on leasing. Reflecting on all this, one cannot help wondering if the writing is on the wall for capital allowances, not just for leased plant and machinery but for all types of asset.

The HMRC document discusses possible ways to preserve incentivisation. If capital allowances are claimed on the right of use asset, this may presuppose capital allowances are preserved in the wider tax system. The alternative of special rates of depreciation for tax – the "lease allowance" - requires computation of tax depreciation thus bringing with it some complexity cost compared to a simple accounts based approach. Given, however, the need to separate out qualifying from non-qualifying assets in order to give a tax deduction only for qualifying assets, this is probably not a serious objection. Taxpayers may in any case opt not to claim the allowance.

What future for long funding leases?

It is hard to believe that the long funding lease rules have now celebrated their tenth birthday. But will they reach those difficult teenage years?

The machinery of the long funding lease code involves tax tests which can be difficult to apply, especially for some operating leases. It also involves complex anti-avoidance legislation as abuses or perceived abuses have been dealt with by amendment of already very detailed prescriptive legislation.

The introduction of the General Anti-Abuse Rule (GAAR) by FA 2013 and changing attitudes to tax planning have contributed to a more stable position for lease taxation with far fewer disclosures under Disclosure of Tax Avoidance Schemes (DOTAS) and far fewer reactive law changes. This means that whilst businesses may not be able to use the former lease planning techniques, they can at least navigate through tax legislation which has stabilised.

That said, the end form of our leasing tax rules including the long funding lease rules is still highly complex. A simplifying reform would be very welcome.

HMRC's accounts-based proposals would mean that the long funding lease rules would be repealed (except to the extent "grandfathering" provisions continue for existing leases). They could also deliver further simplifying benefits.

Will there be "grandfathering" for existing arrangements?

We understand from discussions with HMRC that existing leases may benefit from "grandfathering". If so, where capital allowances are available now to a lessor or lessee they would continue to be available while the lease continues despite the change in lease accounting. Similarly the long funding lease rules would continue to apply to pre-existing leases.

We understand that the mechanism for grandfathering could be similar in spirit to that adopted when the long funding lease rules were introduced in 2006. The headline date of that change was 1 April 2006. However Schedule 8 Paragraph 17 Finance Act 2006 provided that where there was a pre-existing heads of agreement in place on 21 July 2005 (the date when the substance of the new regime was publicised), the resulting lease remained outside the new rules provided certain other conditions were met.

Grandfathering provides certainty to existing lessors and lessees although it will require the current tax rules to remain in operation in parallel with the new rules, potentially for a long period given that some leased assets have lives of 40 years or more.

One consequence of grandfathering the tax treatment of pre-2019 leases is that it would be necessary for lessees and lessors to track pre- and post-2019 leases in their tax computations. If an accounts-based regime is introduced, balances relating to pre-2019 leases would need to be stripped out in order to arrive at the numbers for post-2019 leases which can then be taxed. Whilst such adjustments might cause additional work in the short term, taxpayers may consider this to be a price worth paying for the simplicity of the new tax regime.

What happens if taxpayers are not following IFRS?

Most large UK companies are expected to be following IFRS and thus will need to adopt IFRS 16 from 2019 if not before.

Companies remaining within new UK GAAP will fall into three categories:

- Those using FRS 102. This now comprises standard new UK GAAP and will continue to reflect current definitions of finance and operating leases. It is not expected that this will change until at least 2022;
- Those using FRS 101 (in essence IFRS with reduced disclosure requirements). These companies will be required to follow the same measurement and recognition criteria in IFRS 16 when it becomes effective in 2019; and
- FRSSE: the simplified version of FRS 102 available to small companies. This is expected to continue to reflect current definitions of finance and operating leases.

HMRC are keen to ensure that the same tax solution can apply to all companies. They do not want to have to create different tax rules for different versions of GAAP. They also hope that future as yet unknown accounting changes can also be accommodated, although presumably under Option 1 this cannot be guaranteed.

If therefore an accounts-based option is introduced, UK GAAP (FRS 102 or FRSSE) taxpayers would, if they are operating lessors, obtain a deduction for depreciation with rentals being fully taxable. Operating lessees would obtain a full rental deduction.

FRS 102 and FRSSE finance lessors on the other hand would be taxed only on finance income with no "capital" income or relief (similar to a long funding lessor now) and finance lessees would obtain a deduction for finance charges and depreciation (similar to non-long funding finance lessees now).

Thus UK GAAP taxpayers (other than those using FRS 101) would follow the same tax principles as IFRS taxpayers, but would experience differences in the timing of the recognition of income and expenses for tax purposes compared to IFRS taxpayers.

It remains to be seen whether this difference is likely to have any behavioural impact on taxpayers' choice of accounting but this seems unlikely.

What are the next steps?

There is a consultation period in respect of the discussion document ending on 30 October 2016.

As a parallel process over the next few months HMRC will be holding consultations with industry and the professions. We encourage active involvement and the authors are certainly planning to engage closely with the process.

From discussions with HMRC we understand they plan to refine and focus their proposals over the winter of 2016/17 and then issue a formal consultation document setting out a chosen option around the time of the spring 2017 Budget. Legislation is expected to follow in Finance Act 2018, and to take effect in 2019.

One consequence of this timetable is that early adopters of IFRS 16 will not be able to rely on the new rules but will need to apply section 53 FA 2011 for the interim period.

We expect these proposals will be a major area of focus over the next two years, both in their own right and due to the likely interaction of any new leasing tax rules with BEPS Action 4 and the tax loss carry forward proposals. Clearly taxpayers will want to assess what each of the suggested options might mean for them.

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