Q&A

The proposed tax changes for leased plant

Speed read

HMRC has been working on a project to fix the UK tax code so that – following the introduction of IFRS 16 – the tax rules for leased plant and machinery continue to work broadly as they do currently. On 1 December, HMRC published two consultation documents. *Leasing: tax response to accounting changes* focuses mostly on amendments to the long funding leasing rules with some comment on other areas. *Corporate interest restriction: tax response to accounting changes for leasing* explains the impact of IFRS 16 on the corporate interest restriction and outlines three possible replacements for the finance lease/operating lease divide.

Michael Everett
KPMG
Michael Everett has been a tax consultant with KPMG since 1989. He is currently a director focused on leasing and capital allowances, in particular transport and infrastructure transactions. He worked with HMRC on tax law simplification, where he co-authored *The path to tax simplification* (1995). Email: michael.everett@kpmg.co.uk; tel: 020 7311 6587.

Peter Casey
KPMG
Peter Casey is a senior manager in the fixed asset tax group at KPMG. He advises on a wide range of corporate tax matters, particularly those involving leasing. Email: peter.casey2@kpmg.co.uk; tel: 020 7694 2798.

HMRC has laid out in its 1 December 2017 consultative document *Leasing: tax response to accounting changes* how it will change the long funding lease rules and the tax definitions of finance lease to cope with the new accounting standard, IFRS 16 Leases (IFRS 16). HMRC has given details in the areas of long funding leases and transition; in other areas, it has given indications of the changes that will be made and more detail is awaited.

Why are changes being made?

Under IFRS 16, the familiar distinction between a 'finance lease' and an 'operating lease' will cease to apply for lessees. As a result, aspects of the tax rules will fail to apply as intend ed because they rely on the accounting classification. For example:

- the long funding lease finance lease test;
- CAA 2001 s 67, which applies differently to finance leases; and
- rules on finance leasebacks.

We already have FA 2011 s 53 on the statute book. For tax purposes, this disapplies lease accounting changes occurring on or after 1 January 2011. One of HMRC's proposals is to repeal s 53 with effect from 1 January 2019. That section would not have provided an ideal long-term solution, as it would have required IFRS companies to maintain two separate sets of accounting records. Below, we assess the more organic changes which are to replace s 53.

What changes is HMRC making?

HMRC's plan is to keep the current tax system but with 'necessary adaptations which maintain the effect of the current rules'. This was 'option 1', the most popular choice of those who responded to HMRC's 2016 discussion document.

Key principles are that:

- non-long funding lessors continue to be entitled to capital allowances; and
- long funding lease rules continue to transfer capital allowances entitlement to lessees.

First, we would emphasise that it appears lessors, and lessees who use FRS 102 (or FRS 105), will see very little change.

A decision was needed on two key matters:

1. whether the rules which currently apply to finance leases should in future apply to lessees under all IFRS 16 leases, as these all have a financial liability; and
2. how the rules governing long funding lease capital allowances and rental taxation should apply to IFRS 16 lessees.

The new regime may be seen as a form of hybrid, as the chosen answer to question 1 does not flavour the answer to question 2. It has been decided to preserve a finance lease 'gateway' test applicable to lessees and based on the test in CAA 2001 s 70N. An IFRS 16 lessee will still need to apply this test for tax purposes:

- If the lease transfers sufficient risks and rewards, it will not necessarily be a long funding lease. (The 'not short', lease rentals and economic life tests will still need to be considered.)
- If the lease does not transfer sufficient risks and rewards, the lessee will continue to be treated as having an operating lease for some tax purposes. It will fall outside certain anti-avoidance rules targeted at finance leases.

By contrast, if an IFRS 16 lease falls to be a long funding lease – whether or not this is because it meets the new CAA 2001 s 70N test – all calculation of the lessee's capital allowances and rental deductions will flow as if the lease were a finance lease. Furthermore, if it was an operating lease beforehand, becoming an IFRS 16 lease will now trigger CAA 2001 s 70YA, regardless of the position under CAA 2001 s 70N. This is a point to watch for, as the quantum of allowances could be changed on transition.

The other changes will be scattered widely, as the term finance lease appears in so many places in tax legislation. Not all of these other potential changes are clear yet as, for most of them, HMRC has so far only issued a list of provisions (Annex D to the 'Leasing' document). We need to wait for the draft legislation to see the precise form that changes will take.

Is there any simplification?

The changes in general introduce more complexity in order to retain tax integrity in the face of diverging accounting.

A genuine simplification is the proposal to scrap Conditions A, B and C in CAA 2001 s 70I and simply allow leases of seven years and under to be short. This is an example of paring back complexity and, as such, it is most welcome.

What about leases of land and other non-plant and machinery assets?

The changes to the long funding lease rules described above are confined to plant and machinery.

Elsewhere, HMRC confirms that 'SP3/91' treatment, as described in its *Business Leasing Manual* at BLM32205, will be allowed to lessees under all IFRS 16 leases, such as

leases of property. It is recognised that this will mean that lessees will acquire a new profile for their tax deductions. The straight lining of an operating lease rental over the lease term (or to the next rental review date) will give way to a depreciation deduction together with a finance deduction, which is relatively up fronted because the finance cost is calculated for each period by applying an implicit interest rate to an amortising lease debtor, like a mortgage. Non-depreciated assets may represent a problem area.

HMRC's revised CAA 2001 s 70N (finance lease) test will be used not only in the context of the long funding lease rules, but also to determine whether the lessee falls within various provisions which currently affect finance lessees; for example, CAA 2001 s 67, where the lessee's right to capital allowances depends on finance lease treatment.

What about the corporate interest restriction?

A separate consultation document considers possible approaches to lease rentals in the corporate interest restriction (CIR) context. The objective is to determine the most appropriate way to achieve the BEPS 4 objective (of treating finance lease finance costs like interest) in a world where the finance/operating lease divide is disappearing for some leases. The three options mentioned are:

1. Follow the accounts. IFRS 16 leases and FRS 102 finance leases would give rise to 'interest'.
2. Keep the finance lease/operating lease divide. In this option, IFRS 16 lessees would be able to escape 'interest' treatment if the lease were an operating lease for the lessor.
3. Introduce a tax test for 'funding' leases, which would be based on the funding aspects of the revised long funding lease rules.

This part of the consultation is at an earlier stage compared to the changes to long funding leases and there is no suggestion yet as to which option HMRC favours.

What is the future of capital allowances?

Back in August 2016, some of HMRC's options involved either scrapping capital allowances for leased plant or restricting them to the lessee. Parallel proposals from the Office of Tax Simplification (OTS) have suggested replacing capital allowances with depreciation. The OTS proposals appear to be something for the long term – if they ever occur at all – given the complexity and difficulties of such a move. Our assessment is that UK capital allowances are still going strong and have not been undermined by the current proposals from HMRC.

Taxpayers, such as North Sea ring fence traders, will be glad to see there is no impact on their capital allowances incentives, other than the transition issue mentioned for long funding operating leases. Lessors of long-lived assets under relatively short leases, such as UK rail rolling stock providers, will be reassured to see that capital allowances remain with them; likewise property lessors, who retain capital allowances on qualifying fixtures.

What are the transitional adjustments?

Companies which adopt IFRS 16 in 2019 will be able to rely on the rules at CTA 2009 Part 3 Chapter 14, which allow for taxation or relief for items of profit or loss arising on a change of accounting framework. Specific legislation is expected to ensure that early adopters of IFRS 16 can also tax effect the changes which will arise for them on the repeal of FA 2011 s 53.

The document suggests that on transition to IFRS 16, the recognition of a right of use asset will be assumed for tax purposes to equal the value of the lease liability. This would appear to eliminate many, if not all, of what would otherwise be transitional adjustments. It will be useful to see more detail in this area.

Will there be 'grandfathering' for existing arrangements?

HMRC has avoided grandfathering existing leases and instead has devised ways of grafting new rules onto the old. Full grandfathering would have presented challenges to taxpayers, and the solution adopted appears to work reasonably well for most lessees.

Where a lease of plant is currently a long funding operating lease and the lessee adopts IFRS 16, HMRC has confirmed that CAA 2001 s 70YA (change in accountancy classification of a long funding lease) applies. The lessee needs to reassess the lease as if it were a new lease. It should be noted that an IFRS 16 lease is considered a 'finance lease' for the purposes of CAA 2001 s 70YA, even where it does not fall to be a 'finance lease' under the proposed new CAA 2001 s 70N test.

Assuming the 'new lease' is a long funding lease, the outcome will be to trigger a disposal value at the end of the 'old lease' under CAA 2001 s 70E, based on the expected residual value at the date of transition. The lessee will then have an entitlement to capital allowances under the 'new lease' but their qualifying expenditure will be limited to the present value of the remaining minimum lease payments. This is likely to be a lower amount than the disposal value, given this was an operating lease. There is thus no grandfathering relief for such existing leases and, depending on pool values, some existing operating lessees may find that they have a timing disadvantage on transition to IFRS 16. This could be a starker timing issue for long funding operating leases where the lessee has claimed a 100% first year allowance.

Similarly, in all cases where an existing operating lease comes within IFRS 16, the taxation of the rentals will move to CTA 2010 ss 377 to 378.

What are the next steps?

There is a consultation period in respect of each of the consultation documents. Both periods end on 28 February 2018, which gives good time for digestion of the proposals over and after Christmas. It will be particularly valuable to see draft legislation in the areas referred to in Annex D of the first 'Leasing' consultative document, where it is not clear exactly what form the changes will take.

As a parallel process, HMRC will be holding consultations with industry and the professions. We encourage active involvement in this. The authors are certainly planning to engage closely with this process.

Legislation is expected to be included in FA 2018, and to take effect for accounting periods commencing on and after 1 January 2019. Traditional devils will need to be looked out for in the detail of the drafting.

Taxpayers should assess what the changes mean for them. Operating lessees moving to IFRS 16 should focus the most as they face most obvious changes. The interaction with CIR is as yet something of a known unknown, given the three variant options currently suggested. ■

For related reading visit www.taxjournal.com

- Taxation of leased assets: HMRC's discussion document (Michael Everett & Peter Casey, 23.8.16)