**FINANCE BILL AMENDMENTS CONCERNING 'STRUCTURED ASSET FINANCE ARRANGEMENTS': RESPONSE OF FINANCE & LEASING ASSOCIATION**

This is the response to the amendments recently announced by HMRC to the Finance Bill covering 'structured asset finance arrangements'.

The FLA represents business finance providers, among others, offering leasing as a major product. FLA members achieved £84.7 billion of new business in 2005. Of this £26.8 billion was provided to the business sector and UK public services, representing over 30% of all fixed capital investment in the UK in 2005 (excluding real property). The remaining £57.9 billion was provided to the consumer sector and FLA members represented 25.6% of all unsecured lending in the UK. £18.6 billion of finance was provided to the motor sector.

We have had very close communications with HMRC for several years on the new leasing regime in this year's Finance Bill. Though we have our differences on substance and we would have liked to have seen the whole package in draft, we have welcomed HMRC's openness and timeliness in general. It is regrettable that HMRC has introduced these amendments with such short notice. They should have also been subject to proper consultation on a reasonable timetable. We suspect other sectors will react similarly.

We believe that the new amendments clash with the leasing taxation regime, not only on long funding leases but also on leasing more generally. So we not only seek the exemption the HMRC note indicates might be on offer, but a more general exemption to ensure that the leasing regime is coherent.

**The impact on plant and machinery leasing**

There are serious issues with the new rules on structured finance arrangements ("New Rules") because they fail to operate fairly in their interaction with plant or machinery leasing, for which they have not been designed. For a user of plant or machinery to wish to raise finance on the strength of that equipment is a common and entirely commercial occurrence. Hitherto, a user could do so by way of a sale (or lease) and finance leaseback, with all the commercial benefits of aligning finance to real assets. However the New Rules do not properly address the interaction they will have with the two carefully worked out leasing codes (the code for plant and machinery leases that are Long Funding Leases (LFLs) and the code for other plant and machinery leases). In each case a normal commercial raising of finance, undertaken in the past or in the future, potentially suffers a substantial permanent tax penalty as a result of interaction with the New Rules. Furthermore the provisions even penalise a normal intra-group lease (whenever entered into) of an asset by a parent company to its subsidiary! In the light of all these clearly unintended effects, we consider it essential that there should be a suitable carve-out from the New Rules for equipment

leasing, past and future, as the government itself suggests in paragraph 14 of the 6th June press release, but drafted so as to exclude all leasing.

The Appendix below sets out common examples of problems that are immediately apparent. In practice, given the great complexity of the leasing codes, they will be three amongst a large number of problems likely to emerge. In theory such problems might perhaps be addressed by enormously detailed provisions addressing every possible interaction between the New Rules and each of the two codes for plant and machinery leases, to deal with each and every problem that may be identified. But in practice such provisions would be quite impossible to design and draft in the time before Report Stage of the Bill: after all the LFL code has taken four years to develop. Since the two codes (LFL and non-LFL) for plant or machinery leases have been developed with their own carefully designed checks and balances, a suitable carve-out for equipment leases from the New Rules is the only way forward.

Whilst it is always inappropriate that commercial financings or intra-group transactions should result in a tax penalty, it is wholly unacceptable that past commercial asset financings or group purchases undertaken in good faith as in the examples should be penalised by unplanned interactions between the New Rules and the leasing codes.

**Financing on new equipment**

It would also appear that s774A may apply to new equipment where the market value is higher than the original costs. For example, Company A purchases new equipment from the manufacturer. Subsequently, Company A decides to refinance the equipment and enters into a sale and long funding finance leaseback on the new equipment. If the market value of the equipment is higher than the original costs, then s774A may apply such that Company A would not be able to claim any capital allowances on the new equipment.

**The impact on 'historic' sale and leasebacks**

Furthermore, the package has immediate effect on sale and leasebacks entered into many years ago, if it meets some of the conditions in the proposals. Lessees will be claiming deductions under SP3/91 but it is not clear whether they will still be able to get deductions for depreciation. This is on the grounds that legally they would have been entitled to a full deduction for rentals paid but instead claim interest expense and depreciation - under the New Rules they would only be allowed the interest deduction.

Finance & Leasing Association

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**APPENDIX: EXAMPLES OF PROBLEMS**

**1. Example under the leasing code for plant or machinery leases that are LFLs**

Consider a company ("User") that uses plant or machinery in its trade. Assume the equipment had the following characteristics:

Original cost: £200
Market value (MV): £250
Tax written down value (TWDV): £60.

To raise finance, User entered into (say) a sale and finance back on the equipment for MV (£250) on (say) 30th April 2006, believing that by then it was at last operating under a settled code for lease taxation. Assume the finance leaseback is a LFL. Absent the New Rules, the user would bring a disposal value of £200 into its pool (being £250, capped to Cost by section 62 CAA 2001), thus eliminating future capital allowances (CAs) deductions and recapturing all past allowances given. It would also suffer a capital gain of £50 (£250 - £200). Of the leaseback rentals, the user is only able to deduct the finance charge; however it would bring £250 back into its pool as a lessee under a LFL (draft section 70A CAA 2001, introduced by FB 2006). As intended when the new LFL leasing code was introduced in April 2006, the codes provides a wholly fair outcome, as shown:

Capital cost incurred by the user: £200
Capital gain suffered on refinancing: £50
Tax deductions obtained by user for capital: By way of CAs on original expenditure: £Nil (being £200 - £200 capped disposal value for CA purposes);

By way of CAs on the leaseback: £250.

Total deductions for capital: £200 (being £250 as above, less the upfront capital gain of £50), i.e. equal to the capital cost.

However, unless there is a suitable carve-out for equipment leases from the New Rules, which apply for both new and existing transactions, the financing would generally fall into the New Rules. The user will have already suffered a CAs disposal value of £200. But because this was not "the whole of the advance" of £250 and the remainder of the "advance" is taxed as capital gain, not income (see proposed section 774E(1)), then going forward the lease will be treated as a loan relationship, so User will not get the balance of the allowable £250 of capital rents payable after June 6th. The User suffers a huge tax hit on a wholly commercial financing previously entered into in good faith under what the User believed was finally a settled leasing code.

It appears that the same penalty is likely to be suffered even for future sale and finance leasebacks, because it is not clear that draft section 774B(1) is wide enough to prevent the £200 CA disposal and the £50 capital gain from arising, because although the disposal is part of the commercial arrangements for the financing, it does not necessarily form part of the "relevant effect" within draft sub-section 774B(2). Thus unless there is a suitable carve-out for

sale and finance leasebacks, such finance would be impossible in future in the example circumstances.

**2. Example under the leasing code for other plant or machinery leases**

Assume instead that User's equipment had the following characteristics:

Original cost: £200

Market value (MV): £100

Tax written down value (TWDV): £60.

As before, to raise finance, User entered into (say) a sale and finance back on the equipment for MV (in this case £100) on 30th April 2006. Assume the finance leaseback is not a LFL (e.g. because it is a "short lease", as defined in draft section 70I CAA 2001, introduced by FB 2006). Absent the New Rules, the user would bring a disposal value of £60 into its pool (being £100, capped to TWDV by section 222 CAA 2001), thus eliminating future capital allowances (CAs) deductions by removing the TWDV from the pool. Of the leaseback rentals, the user is only able to deduct the finance charge plus £60 (rather than the full £100) of the principal element of the rents (section 228B CAA 2001). Once again, as intended when the leasing code for non LFLs was amended in March 2004, the code provides a wholly fair outcome, as shown:

Capital cost incurred by the user: £200

Tax deductions obtained by user for capital: By way of CAs before the lease financing: £140 (being £200- £60 disposal value for CA purposes);

By way of rent deductions afterwards: £60 (limited as above).

Total deductions for capital: £140 + £60 = £200, again equal to the capital cost.

However, unless there were a suitable carve-out from the New Rules, which apply for both new and existing transactions, the financing would generally fall into the New Rules. The user will have already suffered a CAs disposal value of £60. But because this was not "the whole of the advance" of £100 (proposed section 774E(1)), then going forward the lease will be treated as a loan relationship, so the User will not get the balance of the allowable £60 of rents payable after June 6th. The User again suffers a substantial tax hit on a wholly commercial financing previously entered into in good faith under what the User believed was finally a settled leasing code.

It appears that the same penalty is likely to be suffered even for future sale and finance leasebacks, because it is not clear that draft section 774B(1) is wide enough to prevent the £60 CA disposal from arising, because although the disposal is part of the commercial arrangements for the financing, it does not necessarily form part of the "relevant effect" within draft sub-section 774B(2).

**3. New asset purchase by a parent of a manufacturing or other group for its operating subsidiary**

Assume instead that User is starting to use the equipment for the first time, which thus had the following characteristics:

Original cost: £200
Market value (MV): £200
Tax written down value (TWDV): £200.

The equipment is acquired new from a third party supplier by User's parent company ("Parent"), which acts as the a the group treasury company, and is then finance leased under a LFL to User. This is a very common arrangement in manufacturing groups.

Under the draft long funding lease code the analysis for the two companies is:

User

As a lessee under a long funding finance lease, User should be entitled to claim capital allowances on the present value of the lease rentals (draft sections 70A and 70C). User should also be entitled to a deduction for finance charges (draft section 502I).

Parent

As a lessor under a long funding lease Parent is not entitled to claim capital allowances on its expenditure on plant and machinery (draft section 34A). However the lessor's taxable income from the lease is not the gross rental income but instead is limited to its gross rental earnings (draft section 502B).

Summary of treatment absent the New Rules

Parent and User are group companies and connected for the purposes of draft section 774A. In this situation the group as a whole claims capital allowances once and only once. The tax consequences of the intra-group lease net out to zero. Thus, as intended when the leasing code for non LFLs was developed over a lengthy period of consultation, the code provides a wholly fair outcome.

Impact of New Rules:

Looking at the conditions in draft section 774A (2).

a. User (the borrower) receives an asset (the advance, in this case the benefit of using the asset under the lease) under the arrangement; this extended and non-intuitive analysis arises because of draft section 774E(3)(a),
b. In accordance with GAAP, User records a financial obligation in respect of the advance, ie the finance lease,
c. User or a person connected with User, ie Parent, makes a disposal (ie the grant of the long funding lease - see for example draft section 25A TCGA 1992 or paragraphs 2 and 9 of Schedule 8 TCGA 1992) of an asset (the security) under the

arrangement to or for the benefit of the lender (Parent) or a person connected with the lender, ie User (in this case the lease of the asset to User),

d. Parent is entitled under the arrangement to payments in respect of the security, ie the asset.

On the basis of the above the intra group long funding lease is a structured finance arrangement.

Looking at draft section 774B

As noted above the lease is a structured finance arrangement. Looking at the relevant effects:

Draft section 774B (2)(a) and (b): an amount of income on which the borrower (User) or a person connected with the borrower, ie Parent would otherwise been charged to tax, is not so charged - in this case the gross rental income of Parent is not subject to tax as draft section 502B under the long funding lease rules limits taxation to Co A's gross rental earnings.

Draft section 774B (2)(c): User or a person connected with the borrower would have become entitled to an income deduction – in this case User's entitlement to capital allowances and a deduction for finance charges under the lease.

The result of draft section 774B (1) is that the arrangement is not to have the relevant effect. This means that Parent is taxable on its gross rentals and/or User has no tax relief for its payments under the lease beyond the deduction for finance charges under the loan relationships code (draft section 774B (5)).

Draft section 774E exceptions from 774B:

Draft section 774B does not apply if the whole of the advance (in this case the benefit of the use of the asset) is charged to tax as income or is fully brought into account as a disposal receipt for capital allowances purposes. To the extent Parent is taxable on the lease rentals this has been limited by section 502B to its gross rental earnings. Accordingly the whole advance has not been brought into charge.

Summary position applying New Rules

The group as a whole obtains no capital allowances for the £200 paid for expenditure with the third party supplier on plant and machinery and/or suffers a tax charge on an equivalent amount in the form of gross rental income for Parent. This is the effect of the provisions as drafted: we cannot believe such a bizarre outcome was intended on ordinary group equipment purchase arrangements entered into in the