FLA RESPONSE TO THE HMRC/HMT CONSULTATION ON LEASING TAXATION

The FLA Response to the Technical Note of 21 July on Leased Plant and Machinery

Introduction

1. The HMRC Technical Note of 21 July 2005 asked for comments by 14 October 2005. This is the response of the Finance & Leasing Association (FLA).

2. The FLA is the major UK industry body for the asset finance, consumer finance and motor finance sectors. Our full members provide asset finance to business, consumer credit, point of sale, credit card and instalment finance. Our associate members provide services or goods to those industries and support the Association's vision.

3. FLA members achieved £93.3 billion of new business in 2004. Of this £25.0 billion was provided to the business sector and UK public services, and represented over a quarter of all fixed capital investment in the UK in 2004 (excluding real property). (The remaining £68.3 billion was provided to the consumer sector and represented 29.3% of all unsecured lending in the UK.) Included in the above total is £18.3 billion of finance provided to the motor sector. FLA members financed at least 50% of all new car registrations in the UK in 2004. Total outstanding business finance in 2004 was £66 billion, 47 per cent of all outstanding finance provided by FLA Members.

4. The Note asked for views on a number of specific aspects of the proposed changes, which we will address. The proposals set out in the Note also raised a number of other issues on which the FLA believes it would be helpful to comment, to help the drafting of the planned legislation for the 2006 Finance Bill. We will deal with all these issues in the order in which they were raised, with the Government's own questions.

General comments

5. In general, we thought the proposals an improvement on previous versions. The Note responded in part to FLA representations – in particular on the change to 5-7 years for the transitional regime, the increases in the NPV and economic life tests and the dropping of the 'specialised use' test . A number of changes are still needed to

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make the proposals workable and the new regime will on present plans still be highly complex for asset finance providers and their clients to operate. This increased complexity conflicts with the Government's aim of simplifying the tax system. It may well have a commercial impact, as well as its effect on the work of tax practitioners. We also have serious concerns about the transitional arrangements, which in some respects are tantamount to retrospective legislation.

Detailed comments

6. .As indicated above, our detailed comments follow the order of the Technical Note.

Current tax treatment

7. The claim that the tax system should not discriminate between loans and leasing in paragraph 15 is debatable, since the Government frequently introduces discrimination into the tax system to influence taxpayers' behaviour, as with company cars, films, energy saving equipment (discussed further below) etc.

8. The claim in paragraph 16 that the proposals would not affect existing leases is wrong. The annex to the Note in effect admits this in paragraph A1. As we discuss below much will hinge on how the term 'existing agreement' is interpreted, but it is difficult to believe that all existing leases will escape.

Transition and scope

9. The 'under construction' test is highly problematical. Whilst the update on HMRC's website on 5 August provides some clarification on the Government's thinking, it still raises very tricky questions of definition. The tests would cause particular problems in projects with long build times, especially where generic assets are being constructed. Is the ordering of steel part of construction? The hiring of a design team? Even with a clear definition of what constitutes 'under construction' some manufacturers may not have information systems in place which would enable them to determine when an asset is under construction – this could be the case for manufacturers of homogenous types of equipment, for example. Furthermore, lessors and lessees may not be aware of whether an asset acquired for leasing was under construction at a particular time which would then require exchanges of information between manufacturers, lessors and lessees. We have in mind the administrative burden this would place on those parties and HMRC in ensuring compliance with the proposed cut-off rules.

10. The 2007 deadline is unrealistic for such sectors. Even the 2006/2009 deadlines are incompatible in these sectors:

11. The FLA believes that the construction tests should be dropped, in favour of a clear 2009 cut-off alone. We do not believe that there would be any additional pressure on the Exchequer if the 2006/7 deadlines were dropped. At a minimum there should be an assurance that all transactions concerning ships, aircraft and rolling stock should only be subject to the 2009 deadline. These arguments apply to combined as well as single assets.

12. We welcome the indication in the HMRC 5 August update that HMRC will take a pragmatic and flexible approach to the 20 July requirements. We take it that that includes deals where events have moved on since the signing of a term sheet: those developments, where documented, could be regarded as the 'deal' as of 20 July.

13. The asset finance industry and its clients are in effect operating blind on deals under discussion between 21 July 2005 and 1 April 2006 that do not fall under the existing regime. No re-draft of the legislation is yet available and the Finance Act will probably not get Royal Assent until July 2006. In these circumstances we believe that the provisions should not take effect until Royal Assent. At a minimum, we seek an assurance that the Government would not seek to backdate any further changes in the regime to 21 July. Draft legislation should be published as soon as possible to begin alleviating uncertainty for lessors and lessees.

14. We are aware of some transactions where the full documents have been executed, and drawdowns commenced, well before 21 July 2005, but where grandfathering will not apply, because of long order books at manufacturers, and extended building periods for complex assets. We consider that this category of transaction should be grandfathered (provided no significant amendments are made) irrespective of the build period tests, since the parties thereto have incurred significant cost in documenting the transactions already, based on the then regime.

15. We understand that this deadline has been set to combat deals which the authorities believe to be structured to avoid tax. This is unacceptable. In effect it amounts to retrospective legislation. This finance was provided under the law that was understood to apply at the time. The HMRC has offered to look at individual transactions on a confidential basis where the parties believe they have been treated unfairly, but have made it clear that the deadline of 21 July will apply whether the authorities believe tax avoidance was the main reason for the structure. This does not meet our criticism that this deadline is imposing retrospective legislation. It is particularly unfortunate that some of those who will be adversely affected are foreign investors. This action will damage the UK's reputation as a place to do business.

16. The industry also needs to know what would happen if an asset were acquired and leased before April 2006 but sold (subject to its existing lease) after 2006 to a new lessor, whether within the same group as the original lessor or otherwise. Which regime would apply? We trust that the legislation – we hope in its draft form – will clarify this issue.

Scope of reform

17. We are disappointed that the accountancy classification rule has not been dropped. It is particularly uncertain in its impact given the recent switch to International Financial Reporting Standards (IFRS) for many businesses and the differences of views in the accounting profession on its interpretation of IFRS on finance leases. So retaining the accountancy classification rule introduces an undesirable level of uncertainty and subjectivity.

18. The FLA reiterates that the NPV and economic life tests are not both needed and make the new regime unnecessarily complex, though as indicated above we welcome the increases in the limits and the dropping of the specialised test.

19. We are reassured to hear from HMRC that the tests will only be applied at the beginning of a transaction.

20. We note that the Technical Note says that almost all of PFI deals would be unaffected . We look forward to seeing the draft legislation in this context and more generally.

21. We consider that the 5% mentioned in 49(b)(i) is too low. In particular at this level, this would harm the haulage sector, commercial vehicles and bus operators. We provided examples in our response to the December 2004 Note.

22. One market which Members have asked the FLA to single out is the NHS. For wider operational reasons the NHS is increasingly seeking longer term finance. So more finance is likely to be made available for periods over five years. The NPV test adds to the risk that NHS finance will be affected. The result is likely to be that longer term finance will become more expensive to NHS Trusts. The fact that NHS Trusts do not qualify for allowances will add to the collateral damage to the NHS.

Election for lessor to opt into the new regime

23. The FLA is glad to hear that the Government is giving further consideration to allowing lessors to opt into the regime. We support the option for lessors to be able to opt to be taxed on an accounts basis. We continue to believe that this option would offer a significant reduction in administrative burdens, at a low Exchequer

cost. In some sectors, such as IT, the impact on the Exchequer could even be positive by bringing leasing business onshore from other EU jurisdictions**.**

Allocation of expenditure to chargeable period

24. The proposals on time apportionment are complex, even by the standards of the proposals more generally.

25. It would be helpful to have a more detailed explanation from HMRC of how the time apportionment rules are intended to apply.

26. The 4 years mentioned in 56 (b) should be changed to 5 years, in line with the broader proposals. This adds an unnecessary complexity: We do not believe that it would put significant additional pressure on the Exchequer though the FLA would be glad to discuss any concerns the Government has

Hire purchase

27. We did not find this section clear on the approach generally to lease arrangements which involve purchase options. Having now had a preliminary discussion with HMRC, we assume that HMRC did not intend to introduce a change that has a significant impact in practice. It would be helpful to have public confirmation of this and also generally of the approach to purchase options included in genuine operating leases which do not represent funding leases.

Double Allowances

28. We have great difficulty with paragraph 73's suggestion that lessees should be deprived of allowances in the circumstances described. It would be unreasonable to deprive a lessee of allowances simply because a business unfamiliar with the information requirements (typically an overseas lessor) was in the chain. SMEs and those leasing from overseas lessors will be particularly affected (which could well be discriminatory). We attach appendices expanding further on this point, with numerical examples.

29. We understand from HMRC that the intention is that overseas lessors do not need to make judgments based on UK GAAP under the proposals. IAS would suffice. We believe that where the overseas lessor adopts its local (non-IAS) GAAP, FA 2005 s50 would cause the test to default to UK GAAP. The new legislation should clarify the position.

Assets leased more than once

30. These proposals on assets leased more than once seem, subject to the legislation and some detailed points, to resolve our specific

concerns with the earlier proposals. The proposal needs to be refined to cater for rolling stock that was included in the British Rail privatisation, preferably by amending the 65% test so it relates to the aggregate of the previous lease terms and the period in British Rail ownership. We would request that the legislation on this area should include equipment leased by a lessor which may be sold to a dealer at the end of the lease and then resold back to the lessor to be re-leased without being used by any other party in between.

Energy saving assets

31. As the Technical Note requested, we polled FLA members on their use of the enhanced capital allowances available for energy saving assets. The response rate was high. Members representing 44% of new business in the last 12 months replied. But the vast majority provided nil returns, indicating that they either did not use these allowances or were unable to identify such business separately.

32. Members representing 7% of new business did report business, but in each case usage was extremely low, totalling around £8.5 million in 2004, for example.

33. We understand that the authorities wanted this data because they were considering abolishing the enhanced capital allowances, on the grounds that they could be a significant source of leakage from the new regime. We do not think our survey supports those fears. On the contrary, this looks like an example of a relief that has been under-publicised. Given the level of oil prices currently and the need for the UK to respect the Kyoto agreement, it would seem very odd to abandon a policy that encourages a more economical use of energy. The FLA would be glad to work with HMRC and the Treasury to publicise this relief in the industry and in the lessee community.

Tonnage tax

34. We are writing separately about tonnage tax.

Overseas leasing

35. The changes on overseas leasing were welcome in principle. As we have said before, we believe that all the associated avoidance rules should go, lest the new regime is in practice unworkable and discriminatory. We would like to see any avoidance legislation in draft.

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Appendix 1
Rules for prevention of double allowances

Per HMRC's Lease Reform Technical Note, where a lessee of a long-funding lease is unable to obtain confirmation that a lessor or superior lessor is not entitled to claim allowances, then the lease will be treated as a long funding lease, but no capital allowances will be available.

Assuming the lessor also treats the lease as a long funding lease and has not claimed allowances, the lessor is taxed on the finance margin, while the lessee obtains relief for the finance margin. No relief is obtained for the capital expenditure incurred. In other words a 'tax nothing' for the capital expenditure arises.

Alternatively, if the lessor does not view the lease as long funding and claims capital allowances, the lessor will be taxed on the gross rents, while relief will be available in the form of capital allowances. In essence the lessor is taxed on its finance margin as expected. However the lessee will also continue to treat the lease as long funding and would only obtain relief for the interest element of the rental payments. Again, a 'tax nothing' arises for the capital expenditure.

This is a very unfair result which could easily arise through no fault of the lessee. Instead, it would seem equitable, that where no confirmation can be provided, the lessee should obtain, in some form, a tax deduction for its genuine commercial expenditure.

The rules are very likely to catch SMEs who will fall into these rules inadvertently, for example, because they are not familiar with the rules, do not understand the importance of the information and/or where the lease is from lessors who are not part of the mainstream leasing market.

HMRC's view is that a default option of treatment as a non-funding lease would be undesirable as it could lead to significant Exchequer cost. However we do not see what the basis for this is after analysing the position.

It will only be appropriate for a lessee to view the lease as a long-funding lease where it is more than 5 years and does not satisfy the 5 to 7 year criteria. For a lease of an asset of, say, 6 years there might be some minimal advantage in having deductions on a profit and loss account basis (SP 3/91 deduction for finance leases or full rent deduction for operating leases) compared to claiming capital allowances on a written down balance basis. However it is a small timing advantage (the PV of the deductions is greater by 1% of what they would otherwise be!). Furthermore even this minimal advantage assumes that the asset life is no longer than 6 years – if it is longer, or there is a residual, the SP3/91 deductions would be reduced, so no benefit would arise. For 7 years and beyond no benefit arises in any event. We are unable to see how there could be any significant Exchequer cost or that not to seek information would be a calculated decision made by the

lessee. For our calculations comparing deductions for rent payments with capital allowances on a £10,000 asset please see Appendix 2.

Therefore we strongly urge HMRC to reconsider their proposal, which we believe is wholly disproportionate in relation to the 'mischief' it is designed to prevent.

Instead tax deductions should be allowed on an SP3/91 basis. If deemed necessary, rules to deter lessees from abusing the rules could be introduced e.g. require them to use the least advantageous method in determining their deductions. Or a statutory deduction could be used, providing relief for the capital expenditure over, say, 7 years.

Alternatively it could be possible to have a threshold, say, for assets over £10 million over which where no lessor confirmation is provided, then HMRC's proposed treatment would apply. For assets below that threshold the SP3/91 treatment would apply.

This type of rule would mean that transactions (if and) where there was benefit in manipulating the rules would be caught, while excluding the majority of transactions where the absence of information reflects the commercial circumstance.

If we have misunderstood your concerns then we should be very grateful for clarification to enable us to attempt to address them appropriately. We reiterate that we feel this is a very unfair measure.

Appendix II: Lessee: Capital allowances v rent deduction

Asset cost	10,000
Capital allowances	25%
Residual value	nil
Borrowing rate	5%

Rent deduction

Lease term	3	4	5	6	7	8
1	3,333	2,500	2,000	1,667	1,429	1,
2	3,333	2,500	2,000	1,667	1,429	1,
3	3,333	2,500	2,000	1,667	1,429	1,
4		2,500	2,000	1,667	1,429	1,
5			2,000	1,667	1,429	1,
6				1,667	1,429	1,
7					1,429	1,
8						1,
Present value of deductions	£9,077.49	£8,864.88	£8,658.95	£8,459.49	£8,266.25	£8,0

Capital allowances

1	2500.00
2	1875.00
3	1406.25
4	1054.69
5	791.02
6	593.26
7	444.95
8	333.71
9	250.28
10	187.71
11	140.78
12	422.35
Present value of deductions	£8,362.73
	£96.76

N.B. The value of deductions on a capital allowances basis is unaffected by the length of the lease