Corporation Tax Reform

Technical Note

December 2004

CONTENTS

1 Introduction

2 Schedular Reform

3 Capital Assets

4 Leasing

Annex A: Further details and examples on leasing

Annex B: Summary of responses to August 2003 consultation document

Annex C: Draft legislation on schedular reform

Annex D: Technical commentary on draft legislation on schedular reform

Annex E: Draft legislation on leasing reform

Annex F: Technical commentary on draft legislation on leasing reform

Comments are invited on the matters set out in this document. Please write to:

William Fry
Inland Revenue
Business Tax
1 Parliament Street
London
SW1A 2BQ

Or email: william.fry@ir.gsi.gov.uk

Comments should reach him by 25th February 2005.

Responses to the consultation, together with the names and addresses of the respondents may be published unless confidentiality is specifically requested. We will assume that if you are replying by email, any confidentiality disclaimer that is generated by your organisation's IT system is overridden unless you specifically include a request to the contrary in the main body of your submission to us. Please note that confidentiality cannot be guaranteed where a response includes evidence of a serious crime.

Chapter 1 - Introduction

1.1 This Technical Note takes forward the Government's commitment in this year's Budget to publish further legislative proposals on the reform of corporation tax, following the two measures (extension of relief for management expenses and reform of the rules on transfer pricing and thin capitalisation) included in Finance Act 2004.

1.2 This document covers all three strands of modernisation initiated in the August 2002 consultation document *Reform of corporation tax*: reform of the schedular system for companies, the tax treatment of capital assets, and tax differences between trading and investment companies. It also takes forward the proposals on the taxation of leasing transactions outlined in the August 2003 consultation document *Corporation tax reform*.

1.3 The document builds on the ideas developed in the previous consultation documents and those put forward by business during the consultation process. In particular, the discussion on the taxation of capital assets recognises the value that business places on the capital allowances system and the difficulties they envisage in using the accounts as a starting point for taxing profits on capital assets or giving appropriate relief for depreciation.

The wider context

1.4 The August 2003 consultation document also initiated a dialogue on the wider context in which corporation tax operates, and responses indicated that business was keen to discuss this topic. The areas of particular interest were the tax implications of International Accounting Standards, on which a steering group is now operating under the aegis of the Business Tax Forum, and issues arising from the wider international context.

1.5 Budget 2004 confirmed the Government's commitment to continuing the wider-ranging dialogue on international issues, with a view to maintaining the competitiveness and fairness of the UK corporation tax system while ensuring that it remains robust. A series of meetings is now in progress to discuss the wider context under the auspices of the Corporation Tax Reform consultative groups. These groups, drawn from business and representative bodies, were set up following publication of the August 2002 consultation document and have played a continuing and constructive role in the consultative process.

Your contribution

1.6 The Government is very grateful both for the valuable contribution made by the membership of these consultative groups and for the 148 written responses to the August 2003 consultation document and accompanying Background Notes. Summaries of these responses (to the extent these were not included in the Technical Note issued in December 2003) are at Annex B of this document.

Principles of corporation tax reform

1.7 As announced in Budget 2004, the proposals included in this Technical Note focus on those areas where the tax system may create unjustified barriers to modern commercial activity. This focus is consistent with the principles of competitiveness and fairness underlying the Government's reform programme so far.

1.8 The Government's reforms since 1997 have increased the fairness and competitiveness of the corporation tax system. The Government is committed to continuing its dialogue with business in order to ensure that the UK has a modern corporate tax system, which does not create barriers to innovation or commercial activity. The Government is also committed to ensuring that businesses continue to contribute their fair share to the provision of public goods and services. It will therefore continue to tackle abuse of the tax system, to close loopholes and to look at ways of addressing any structural features of the system that are being exploited. The Government recognises that avoidance may distort commercial activity and competition, which is unfair to the wider body of taxpayers.

Schedular reform

1.9 **Chapter 2** of this document sets out further proposals to modernise the schedular system for companies, including draft legislation covering the core elements. The changes would create a new source of income, with a single set of basic computational rules and a single set of loss relief rules, for the whole of a company's "operating business". The operating business would include trading income and expenses, letting income and expenses, and certain items of miscellaneous income currently within Schedule D Case VI. This would provide a more generous treatment for losses than currently available and would need to be balanced with effective provisions to prevent avoidance. In addition, changes would be made to the way tax relief is given for payments currently treated as "charges".

Taxation of capital assets

1.10 **Chapter 3** addresses the taxation of capital assets. As announced in Budget 2004, the Government has concluded that capital allowances should be retained, rather than being replaced by relief for commercial depreciation, but continues to consider ways in which the system could be modernised.

1.11 The chapter therefore discusses ideas for modernising the taxation of capital assets by building on those features of the capital allowances system valued by business. The chapter also includes options to modernise the capital allowances system for cars. This was highlighted in responses to the August 2003 consultation document as an area in which business would particularly welcome reform. Chapter 3 also discusses the treatment of abortive capital expenditure.

Leasing

1.12 **Chapter 4** sets out the Government's proposals to reform the tax treatment of leases of plant and machinery where they are essentially financing transactions ('funding leases'). Some more detailed issues are discussed in **Annex A**.

1.13 The current tax rules treat loan finance and leasing finance differently even though the commercial effect – that the business uses the asset while another party finances its purchase – may be virtually the same. It is economically undesirable for the tax system to bias the decision between lease finance and loan finance. The Government has therefore decided to reform the taxation of leased plant and machinery, to ensure that the choice between different forms of finance is driven by commercial rather than tax considerations.

1.14 The development of the new regime for funding leases has benefited from consultation with the leasing industry following the publication of outline proposals in the August 2003 consultation document.

Trading and investment companies

1.15 The August 2002 and 2003 consultation documents discussed the differences in the tax treatment of trading and investment companies. And Finance Bill 2004 modernised the treatment of management expenses so that relief is available to companies with investment business, regardless of whether they qualify as investment companies. Reform of the management expenses rules had been identified by business as a priority during the consultation process.

1.16 The proposals on schedular reform set out in this document would be a further step forward in reducing these distinctions, bringing trading income and property investment income within the same 'operating business' source.

1.17 A further issue, highlighted by business, was the current scope of the substantial shareholdings exemption introduced in Finance Act 2002. In the light of the responses received, the Government will continue to consider the case for extending the exemption to disposals by shareholding companies that are not within the definition of a trading company (or a trading group). However, as the existing exemption has only been in effect since 1 April 2002, some of the behavioural consequences of its operation are just starting to be discernible. The Government will therefore keep the effects of the exemption under review.

1.18 In particular the Government would like to understand better the implication of any extension for the investment trust and venture capital industries. For example, a change might mean that some investment companies would choose to relinquish their approval status under section 842 ICTA. There might also be more general implications for the way venture capital investments are structured and for the effectiveness of the current tax-favoured venture capital schemes.

1.19 Therefore, the Government would like to use the opportunity of this round of consultation to explore further the behavioural effects of extending the exemption with the venture capital industry and others.

1.20 The August 2003 consultation document made clear why the Government believed that:

- the trading company restriction should not be removed for the company in which the shares are held; and

- any extension to the exemption in the case of the shareholding company should not include close-investment holding companies.

1.21 The Government’s view on these issues remains unchanged.

Other material

1.22 **Annex B** summarises the responses to the August 2003 consultation document insofar as these were not included in the December 2003 Technical Note on transfer pricing and management expenses.

1.23 The document also includes draft legislation on the core provisions of both schedular and leasing reform, together with supporting technical commentaries. These can be found at **Annexes C-F**.

1.24 A separate document containing **Partial Regulatory Impact Assessments** on leasing and schedular reform is being published alongside this Technical Note.

Consultation responses

1.25 Comments are invited on the issues set out in this Technical Note and on the draft legislation. These should be received by 25 February 2005.

Chapter 2 – Schedular reform

Introduction

2.1 Since its introduction some 200 years ago, one of the foundations of income tax (and more recently corporation tax) has been the concept of the "source" of income. UK tax legislation has, over time, developed separate sets of rules for calculating the taxable profits, and allowable losses, from different sources of income – within the various schedules and cases within schedules.

2.2 Although companies are required for accounting purposes to identify separately certain items of income and expenditure, the tax system does not simply follow these distinctions but also imposes different distinctions for computing each source's profit or loss for tax purposes. Any losses are then subject to their own source-specific loss rules, which in some cases can serve to ring-fence losses, preventing the potential aggregated result of a company's varied activities being recognised in its actual tax computations.

2.3 Responses both to the August 2002 and August 2003 consultation documents came out strongly in favour of reform of the current schedular system. A summary of responses is provided at Annex B to this note. The most favoured change was also the most fundamental one, namely to allow full pooling of all types of income and expenditure, with any overall loss being fully relievable against later years' income of any description. But respondents also recognised that the Exchequer cost of such an approach could be prohibitive and saw benefits, particularly for SMEs, in a more limited approach of pooling only trading and letting income and expenses.

2.4 Respondents were also of the view that whilst assimilating losses incurred prior to any new regime (so-called "pre-commencement losses") to losses incurred within the new regime was their ideal, it was important that any more limited scheme for allowing pre-commencement losses into the new regime had to be based on flexibility and simplicity.

2.5 This chapter outlines the Government's proposals for schedular reform for companies. The proposed reform would create a new "operating business" source which will encompass trading and letting income, together with some miscellaneous income currently chargeable under Case VI of Schedule D. The chapter also contains proposals for reducing complexity in the taxation of the profits of different types of life assurance business. It concludes with a proposal for abolishing "charges on income" (and giving relief for such expenditure in an alternative way).

The present system

2.6 The Corporation Tax system divides income into separate categories, depending upon the "source" from which it is derived - income from property, trading income, income from non-trading loan relationships and derivative contracts etc. The main effects of this are that:

- companies first have to apply specific computational rules in arriving at the profit and loss from each source - including rules concerned with the timing of income and expenditure. Although the rules have been brought closer together over the years, often by reference to generally accepted accounting practice, there remain significant differences;

- if the result for one or more of the separate computations is a loss, there are then sets of rules which determine how such a loss can be relieved.

2.7 UK and international accounting standards and the accounting provisions of the Companies Act 1985 (where applicable) require some separate identification of different types of income and the expenditure incurred in earning them. In addition there are computational changes that are required by tax law. But it is the way that loss relief operates for different sources which is particularly significant for businesses.

2.8 There are similar consequences for the life insurance industry. Life assurance companies can carry on up to seven different types of insurance business. One of these (basic life assurance) is taxed on the I minus E basis. The other six are taxed more like conventional trades, but are each taxed separately with subtle differences between them. One result of this is that there is no set-off of losses from one type of business against the profits of another.

Reasons for change

2.9 There are a number of arguments for change. Currently profits and losses are often assessed differently depending on their source with the result that losses from one activity cannot be offset against profits from another. For instance, whilst a company can carry forward a letting loss against a trading profit, it cannot set a trading loss off in the same way against a letting profit.

2.10 For any particular activity or set of activities, taxing profits but not giving relief for losses may well provide a disincentive to pursue those

activities. If this acts as a brake on enterprise and innovation, the distortion is particularly damaging. On the other hand, if losses were relieved without any restriction, the increased burden on profitable business needed to meet the resulting Exchequer cost would also be damaging economically.

2.11 This raises the question of how far flexibility for loss set-off should be extended. While there are arguments for allowing offset of losses within the same economic unit, the same may not be true for a transfer of losses (or profits) between activities and entities that are not closely related. This suggests any reform should focus on those specific areas where interdependencies are greatest i.e. where more freedom to offset profits and losses will be of greater economic importance.

2.12 Respondents to the 2003 consultation document unanimously supported schedular reform, on the basis that the current rules are complicated and fail to represent modern economic reality. Of the two suggested options for reform - pooling trading and letting sources or full pooling of all sources - most favoured full pooling as offering the greatest flexibility for loss relief.

2.13 However the Government believes that there are strong arguments in support of an approach which focuses on the areas of greatest interdependence between business activities, delivers compliance savings and adopts an imaginative approach to delivering the outcome. For a large number of companies with more than one source of income, the amalgamation of trading and letting sources will provide not only flexibility in terms of offsetting losses but should also allow for some compliance cost savings from pooling trading/letting income and expenditure into one source and one computation.

2.14 It is therefore expected that this proposal will deliver significant benefits for many companies, with a much more limited Exchequer cost than full pooling. The point was made in response to the 2003 Technical Note that pooling trading and letting would encompass most smaller companies' major sources of income. The Government has also listened to those representations that suggested the new source could be expanded beyond trading and letting, by including income currently taxable under Case VI of Schedule D.

Proposed changes

2.15 The proposed changes involve an important recasting of the schedular system for companies. The intention is to create a new source of income – which we have termed 'operating business' - out of a company's trading and letting activities, both in the UK and overseas, and also to include within it some items of miscellaneous income currently within Case VI of Schedule D. It would be perfectly possible for a series of quite different trading activities, carried on simultaneously or successively by a company, to be comprised within a single operating business.

2.16 This approach goes beyond simple aggregation of (separately calculated) trading and letting profits. Instead there will be one operating business with one set of basic computational rules. This will allow those companies that derive most of their income from trading/letting activities to calculate their profits/losses for tax purposes on a more straightforward basis. However, it should be noted that the Double Taxation Relief rules, which allow a credit (with limits) by reference to foreign tax on the same income or gain, will still require the relevant income to be separately identified.

2.17 Creating a new source, with one set of rules and one computation should provide for greater compliance savings than, for example, by making adjustments to the loss relief legislation at section 393 Income and Corporation Taxes Act 1988 (ICTA) to allow trading losses to be carried forward against all future trading and letting profits. Draft legislation outlining the basic structure for this "operating business" is also published today, along with a technical commentary. These can be found at Annexes C and D.

2.18 One major issue to be addressed is how the source should be identified in statute. The Government would prefer an approach which defined the new source residually and this has been adopted in the draft legislation. The new source would comprise all of a company's commercial activities, subject to the specific exclusion of some incomings and outgoings. Such exclusions would include:

- capital gains and allowable losses within the Taxation of Chargeable Gains Act 1992 (TCGA);

- non-trading credits and debits within the loan relationships, derivative contracts and intangible fixed assets rules, other than those referable to letting activities;

- most dividends; and

- management expenses.

2.19 This would enable the profits and losses of trading/letting activities to be computed by means of a single set of computational rules, rather than aggregating profits and losses, calculated separately, from each source.

2.20 The Government would welcome views on this approach and whether, if the residual approach is felt to have disadvantages, an appropriate alternative would be to define the new source by the sum of its parts - that is, as being so much of a company's business that consists of trading, property letting and other included activities. Views on this alternative approach would also be welcome.

2.21 The suggested changes represent a fundamental rethink in the way the corporation tax rules are structured. Merging trading and letting income and expenditure (and some Case VI income) will involve significant legislative change - both in terms of ensuring a common computational approach, appropriate relief for losses (including those arising before the new rules apply) and a review of references in the Taxes Acts to trading and letting to ensure the proposed changes do not generate any unwanted consequential effects. The Government recognises that reform involves costs for both business and the Exchequer, and would welcome comments on whether the benefits from the proposed changes outweigh any potential disruption.

Operating business source

2.22 The Government would want to model the rules for the new operating business source on the current computational rules for trades and property businesses - and thus, for example, require deductible expenses to be incurred wholly and exclusively for the purposes of the operating business. But there will be circumstances where it is necessary to retain the concept of a “trade”, just as there will need to be some special rules preserved to deal with particular incomings and outgoings, such as premiums on the grant of a lease.

2.23 And there will also be a number of computational rules which will now need to refer to "operating business" rather than "trade" or "letting business", notwithstanding the fact that such a change will not fundamentally alter the practical effect of the rule in question.

2.24 In amending the computational rules regard has been had to the detailed work of the Tax Law Rewrite project on its Income Tax (Trading and Other Income) Bill, for example in rewording and sometimes discarding outmoded elements of the current rules prohibiting the deduction of certain expenses in section 74 ICTA. The CT reform proposals would contribute, along with the Rewrite project,

to the modernisation and streamlining of the tax rules for businesses both incorporated and unincorporated.

Loss Relief

2.25 The current loss offset rules do not treat trading and letting losses in the same way. The intention is to have one set of operating loss rules, which would not require the operating loss to be split into trading and letting components. The operating loss would be capable of being set off against:

- other profits (including capital gains) for the accounting period in which the loss arises;
- total profits for the previous 12 months;
- total profits of fellow group members of the same period by way of group relief;
- future profits of the operating business.

2.26 Currently non-trading loan relationships deficits, which may include interest relating to a Schedule A business, and Schedule A losses, can be set against future capital gains as well as Schedule A profits, whereas trading losses (including interest paid for trade purposes) can only be set against trading profits. The Government would welcome the views of respondents on the practical effects of the proposals, if operating business losses were not relievable against future gains.

2.27 The more flexible treatment of operating business losses could create additional opportunities for avoidance through manipulation and loss or profit selling.

2.28 Whilst the Government recognises that a modern corporate tax system must avoid creating barriers to innovation or commercial activity, it is equally important that there is a balanced approach and that businesses contribute their fair share to the provision of public goods and services. It will therefore be necessary to ensure that effective protection is provided to the Exchequer and that the various anti-avoidance provisions in the Taxes Acts are fully effective and continue to be so - particularly in those areas that could be directly affected by the proposed changes.

2.29 The loss-buying rules at sections 768 to 768E and Schedule 28A ICTA will require particular attention in the context of this package. While there are arguments for giving relief for losses to the companies which,

in economic terms, have borne them, the case for permitting others to obtain relief for those losses is less compelling.

2.30 Given the increased flexibility for offset of losses under these proposals, the Government will need to protect itself against potential manipulation of any new rules and therefore consideration will be given to how effective protection against loss and profit selling can be ensured. This could involve amending the existing rules in sections 768 to 768E or alternatively it might be more appropriate to review the continuing relevance of the existing provisions and make broader changes. As now, any legislative protection is likely to involve restriction of the set-off of losses, where specific conditions are satisfied.

2.31 And more generally, it will be important to ensure that the various anti-avoidance provisions in the Taxes Acts remain robust under the new regime.

Pre-Commencement Losses

2.32 The total of companies' unused trading losses runs into the tens of billions of pounds. Under current rules such losses, when carried forward, can only be set off against future profits arising from the same trade. Allowing all trading and letting losses arising before the commencement of the new operating business source to be fully offset against future profits from any activities within the new source is likely to be prohibitive in exchequer cost terms. But at the same time the Government wishes to preserve as far as possible companies' expectations as to the future availability of relief for such losses.

2.33 The Government would welcome comments on the most appropriate way to give relief for pre-commencement losses, in a way that will give companies a degree of certainty, whilst at the same time not creating unnecessary complexity.

Special Cases

2.34 In addition the Government would want to consider what arrangements need to be made in the case of the special regimes that currently exist in the corporation tax system - such as for oil and gas companies, CFCs, companies carrying on insurance business (including at Lloyd's), film companies etc. The current “ring fence” which applies to profits from UK oil and gas activities and which forms the basis on which the supplementary charge in respect of ring fence trades under section 501A ICTA 1988 is levied, for example, will need to be preserved under any new approach.

Life Insurance Companies

2.35 Life insurance companies may carry on up to seven types of insurance business, with restrictions to the offset of losses from one type of business against the profits of another. From consultation with the industry in the light of the 2003 consultation document, there was unanimous support for the amalgamation of six of the types of insurance business (i.e. all those where gross roll-up of the investment return applies and not I minus E) into one common tax base. This would include long-term business, which is not life assurance business (mostly permanent health insurance business) as well as the gross roll-up categories of life assurance business. Such a move would greatly simplify complex tax legislation and allow greater set-off of losses.

2.36 But complete pooling of pre-commencement losses here would, as in the general case discussed above, be costly, as there is a substantial overhang of pension business losses. Accordingly it is proposed that pre-commencement pension business losses should be streamed and only be set against a proportion of the total 'gross roll-up' business profit. That proportion would be based on a comparison of the pension business liabilities with the total gross roll-up liabilities and would not involve the retention of the existing rules for computing pension business profits.

2.37 The amalgamation of six categories of business into one would also enable a fresh look to be taken at the rules for apportioning investment return to the categories. These will in any event need consideration in the light of forthcoming changes to the regulatory returns and accounting rules for life assurance business.

2.38 In addition the main operating business rules will need to be modified where the I minus E basis applies, to ensure that income from investment properties in a company's portfolio is taxed under that basis.

Consequentials

2.39 There are two further areas which will have to be considered carefully, namely:

- those parts of the tax legislation (other than those concerned with the computation of trading or letting profits) where the concept of a "trade" or "property business" is used and remains appropriate; and

- those special codes within the legislation, such as capital allowances, whose application extends into the computation of the operating business profit.

2.40 It may be that many of these sorts of changes, where required, would be appropriate to secondary legislation but this will be subject to later, more detailed consideration. The Government would expect to make mechanical changes by way of regulation, as was done for the changes to management expenses following the changes announced in Budget 2004.

2.41 One other category of business expenditure, which it is appropriate to consider in the context of schedular reform, is the treatment of "charges on income".

Abolition of charges

2.42 Like the schedular system, charges have a long history. With the advent of Corporation Tax, companies making payments within what is now section 349 ICTA were required to deduct and pay over tax, using the mechanism now at section 350 and Schedule 16 ICTA. Before Finance Act 1996 the list of "charges on income" was still fairly extensive but with the introduction of the loan relationships legislation and other subsequent legislative changes, the list has shortened considerably.

2.43 Charges for companies now comprise, by virtue of section 338A ICTA (as amended by Finance Act 2002):

- donations to charity within section 339 ICTA;
- amounts falling within section 587B ICTA (gifts of assets to charity); and
- annuities and other annual payments paid by non-traders.

2.44 The intention would be to abolish charges on income for CT purposes and treat such payments as currently fall within the definition as either:

- deductions in computing profits of an operating business; or
- expenses payable under s76 ICTA where paid in connection with a life assurance business.

Points on which comments are requested

Operating business source

2.45 Draft core legislation has been published at Annex C, together with a technical commentary at Annex D and comments would be welcomed on the extent to which the approach currently adopted meets the aims of modernising the schedular system. The following questions seek to bring out some of the key issues.

2.46 It would be helpful if companies could provide specific examples of the benefits (and how significant they are) that they would expect to derive from being able to pool trading and letting income (together with related Case VI items).

2.47 How effective is the "residual" approach - creating the new operating business source and then defining out those items, such as dividends, non-trading/letting loan relationships etc, which are not within its ambit?

2.48 The new operating source will include both trading and letting loan relationships. Do respondents envisage significant difficulties in separating these from loan relationships entered into for other purposes?

2.49 Are there particular concerns about the impact on the availability of double taxation relief?

2.50 Is the proposed treatment of losses arising from the new source the most appropriate?

2.51 How should relief be given for pre-commencement losses, assuming it would not be possible to give immediate full relief for all such losses against future profits from the new operating business source? And should there be specific rules for smaller companies?

2.52 What issues will need to be addressed in the case of special regimes such as those mentioned in paragraph 2.34?

2.53 Given the increased flexibility how could the Government best protect itself against manipulation through loss buying and profit buying?

2.54 Are the current loss-buying rules regarded as providing sufficient protection for the Exchequer whilst providing certainty of outcome for business?

Life Companies

2.55 Do the proposals for life insurance companies seem appropriate and are there likely to be any practical difficulties?

Abolition of charges

2.56 Is the abolition of charges (and their recasting as operating business expenses or life assurance business expenses) a useful proposal? Are there likely to be any practical difficulties?

Chapter 3 – Capital Assets

Background to the current consultation

3.1 In the previous rounds of consultation, the Government has set out its strategy for the taxation of capital assets:

- to move to a more coherent and comprehensive system for taxing capital profits and relieving capital expenditure; and

- so far as possible to reduce the distortions within the current regime – for example, between the taxation of capital and income profits and between relief for expenditure on different types of asset.

3.2 The August 2003 consultation document discussed two possible approaches designed to further these objectives: to align the tax treatment of capital assets more closely with the commercial accounts or to build on the current capital allowances regime.

3.3 That document opened up a wider debate on the role of capital allowances and their future within a modernised corporation tax system. It was clear from the consultation responses and from discussions with business, that companies particularly value the certainty and flexibility that the capital allowances system offers for expenditure on plant and machinery. The pooling system is a popular feature of the current regime.

3.4 Business was concerned that basing the taxation of capital assets on the accounting treatment would bring uncertainty and complexity at a time when International Accounting Standards were in a state of flux. A further concern was that numerous adjustments to accounts figures would be needed if incentives and other reliefs were still to be delivered through the tax system.

3.5 The Government listened carefully to the views expressed in this debate. In Budget 2004, the Chancellor announced that he had concluded against moving to a relief based on accounts depreciation and that the capital allowances system would be retained.

3.6 The Government would now like to take the debate on the taxation of capital assets a stage further – and in particular to look at how future reforms could build on the existing capital allowances regime to put in place a more coherent and comprehensive regime for both taxing capital profits and relieving capital expenditure.

3.7 This chapter therefore looks at options for modernising the capital allowances regime that could:

- deal with all expenditure and receipts on an income basis; and
- modernise the regimes for plant and machinery and buildings.

3.8 It also discusses options for reforming the allowances given for expenditure on cars in order to simplify the rules and deliver environmental benefits. Business identified reform of these rules as a high priority in their responses to the August 2003 consultation document.

3.9 The chapter concludes by discussing the treatment of abortive capital expenditure in the light of the Government's decision not to take forward the option of aligning the taxation of capital assets more closely with commercial accounting.

Pooling and the taxation of capital profits

3.10 The Government has recognised that companies see the capital allowances system as an important component of a modern and competitive corporation tax system. It therefore wants to explore options which would modernise the taxation of capital assets by building on those aspects of the capital allowances system which are valued by business.

3.11 Companies have made it clear during the consultation process that they particularly value the pooling system for plant and machinery allowances. They see this approach as delivering certainty and flexibility; and it smoothes profits and removes the need to track assets individually.

3.12 It would be possible to develop the pooling mechanism in order to:

- deliver similar benefits over a wider range of assets than plant and machinery; and
- tax all profits on the disposal of qualifying assets on an income basis.

3.13 Where capital expenditure qualifies for allowances, the current tax system deals with disposal proceeds through both the income regime (in so far as the proceeds do not exceed original cost) and the capital gains regime (to tax any profit over original cost).

3.14 Instead, it would be possible to use capital allowance pools to deal with all qualifying expenditure and all proceeds. A reformed system could tax capital profits as income by way of an adjustment to the pool balance going forward or through a system of balancing adjustments. The effect would be to bring gains into income through a familiar tax mechanism.

3.15 This would allow assets that qualified for capital allowances to be removed from the capital gains regime and therefore remove the complexities which arise from using two regimes to tax one profit. And it would allow deferral of tax when capital profits are reinvested to extend beyond the range of assets that currently qualify for capital gains roll-over relief.

3.16 The Government would be grateful for the views of business on the broad approach discussed above.

3.17 The sections that follow look in more detail at how this approach could be developed in the case of plant and machinery and buildings.

Plant and Machinery

3.18 Expenditure on plant and machinery is normally pooled for capital allowance purposes. As new assets are acquired, the expenditure is added to the pool and any sale proceeds are deducted (in so far as they do not exceed the original cost of the asset being disposed of). There are exceptions to this pooling process such as the treatment of cars costing over £12,000 and assets subject to a short life asset election where allowances are computed separately for each asset.

3.19 The allowances are given against income profits, as a deduction in computing trading profits or the profits of a letting business or, in the case of assets relating to a company's investment business, as management expenses. Where the pool is exhausted and a balancing charge is generated, this too is taxed as part of the income profits.

3.20 Where the proceeds from the sale of an asset do not exceed the acquisition cost, the full amount of the proceeds is deducted from the capital allowances pool. In this way allowances are given only on that part of the cost of the asset consumed in the business. Any loss on the tax written down value is relieved through the pool. Where an asset is sold at a profit over the original cost, the amount that is deducted from the pool is limited to that cost and the profit is taxed separately as a chargeable gain.

3.21 Complex provisions are required so that the two regimes, capital gains and capital allowances, can operate together on the one transaction giving relief for the cost of the asset only once, taxing profits once and relieving losses once.

3.22 A new regime could remove these complexities and provide that profits and losses on disposal of plant and machinery assets were dealt with solely through the capital allowances regime.

3.23 The smoothing effect of the pooling system could provide a similar relief from immediate taxation of profits as offered by capital gains roll-over relief. This would allow a form of deferral relief to apply to gains on any plant and machinery assets (and not just to gains on the assets that currently qualify for capital gains roll-over relief). Where a pool was exhausted by the sale of an asset it might be appropriate to allow a period of grace before a charge was triggered (in the same way that capital gains roll-over relief allows a period of three years after a disposal for reinvestment to take place).

3.24 Special consideration would need to be given to the implications of any changes for sales of North Sea assets.

3.25 It would also be necessary to consider the extent to which any other special reliefs or computational provisions within the capital gains regime would need to be adapted within a reformed capital allowances regime. The Government would like to hear the views of business on this issue. But its initial view is that the effect of pooling could reduce the need for measures designed to give continuity of treatment where assets move around a group of companies.

Buildings

3.26 Expenditure on industrial buildings and structures, agricultural buildings and hotels qualifies for allowances at 4%. This allowance is computed on a straight-line basis and is based on the original cost of construction. No adjustments to allowances are made on a sale of a building more than 25 years after first use; and similarly no allowances are available to the purchaser of a building under these circumstances. A number of respondents to the August 2003 consultation document regarded the current regime as complex and as imposing high compliance costs.

3.27 As part of a reform of the taxation of capital assets, it would be possible to modernise buildings allowances by adopting a similar approach to that described above for plant and machinery. This would adopt the pooling approach that business regards as one of the main benefits of the current system of plant and machinery allowances and would also bring profits and losses on buildings into the income regime.

3.28 Buildings allowances might therefore operate, like the plant and machinery allowances system, on the basis of a pool of expenditure with an annual writing down allowance on the reducing balance. And all disposal proceeds could be deducted from the pool, generating balancing adjustments where appropriate.

3.29 A new allowance might be based on the actual cost of a building to its buyer (rather than the original construction cost). This would exclude the cost of the land. But it would still be possible to tax (or relieve) the element of any gain (or loss) that relates to land on an income basis through the capital allowances pool – this could be done by introducing the cost of the land into the pool at the point of disposal and then deducting the full disposal proceeds (both for the land and the building) from the pool. The effect would be that the profit or loss on the whole property would either be taxed or relieved either by way of the pool going forward, or through a balancing adjustment.

3.30 This approach could provide a template for the design of any new commercial buildings allowance and enable these assets to be removed from the chargeable gains regime.

3.31 Although current law does not provide a specific relief for commercial buildings, in practice a significant proportion of the cost of a building may qualify for plant and machinery capital allowances – for example the cost of integrated facilities such as lifts, air conditioning or electrical systems. Few modern buildings are built without these integrated facilities at the outset. There would therefore be a strong case for any wider allowance for expenditure on buildings to encompass all the elements that make up the total cost of a building, including these integrated facilities.

3.32 A guiding principle for such a reform could be that the expenditure needed to bring a building to the point at which it would be regarded as fit for normal use could be categorised as expenditure on the building and not as expenditure on plant. One way of achieving this might be through a list, set out in legislation, of standard elements in the construction or refurbishment process. Such a list could follow modern commercial practice and include, for example, the substructure and superstructure of the building, mains supplies (electricity, water and gas), lighting, heating and cooling systems, lifts, sanitary fittings and waste disposal systems.

3.33 On the other hand, items of plant that were installed in a building for an industrial process taking place inside the building could retain their status as plant and machinery. Examples include production lines and printing presses. Energy-saving technology used in a building might also need special treatment.

3.34 Defining a building in this way, within the context of a reformed and expanded buildings allowance, might better reflect economic and commercial reality and could offer compliance savings, both for taxpayers and for the Revenue.

Transition

3.35 The transition to any new regime would need careful consideration and the Government would be grateful for the views of business. In the case of buildings, where the holding period is long, fairness, complexity and Exchequer cost would need to be taken into account in considering any options. The Government recognises that the approach to transition would need to take account of indexation allowances which had accrued up to the commencement date, given that indexation would not be a part of a capital allowances system going forward.

Companies and unincorporated businesses

3.36 The discussion above has set out options for modernising the corporation tax treatment of plant and machinery and buildings. But the capital allowances system applies to assets held by all businesses. The implications for any reforms for the taxation of unincorporated businesses and for the interface between companies and the unincorporated would need careful consideration.

Cars

3.37 Responses to the August 2003 consultation document indicated that business would particularly welcome modernisation of the capital allowances regime for cars. The current system for cars costing over £12,000, which requires each car to be tracked separately, was felt to be outdated and to impose a disproportionate compliance burden.

3.38 The Government recognises that the current system has been in place for many years and that the context in which it operates has changed considerably during that time. As part of the current programme of modernisation, it is therefore appropriate to consider options for change, which are also consistent with wider government objectives on the environment and on maintaining sound public finances.

The current regime for cars

3.39 Under the current rules, expenditure on cars costing up to £12,000 goes into the general P&M pool. But there are special rules for cars costing more than £12,000:

- new expenditure is not added to the general P&M pool;
- capital allowances for each car are computed separately;
- the yearly allowance for each car is restricted to £3,000 or 25% of the balance of expenditure (whichever is the lower); and
- an adjustment is made when the car is sold to bring the total allowances given in line with the actual depreciation suffered.

3.40 There are also rules that apply to businesses that lease cars costing more than £12,000. These restrict the amount a business can deduct in its accounts for tax purposes for its lease rental payments.

3.41 There is a special regime for cars with low CO_2 emissions. Cars, which produce emissions of up to 120 g/km qualify for 100% first year allowances, and the restrictions described above do not apply.

Options for change

3.42 One option the Government would like to explore, and which would simplify the system considerably, would be to pool expenditure on some or all cars in a similar way to the pooling of expenditure on most other plant and machinery. The expenditure in this pool would attract writing down allowances at a rate lower than the normal 25% rate in order to limit the cost to the Exchequer. This was an option suggested by some respondents to the August 2003 consultation document.

3.43 As an alternative option, the Government is also considering whether the rules could be reformed to fit with the Government's wider environmental objectives, bringing the capital allowance treatment of cars more into line with recent changes to company car tax and Vehicle Excise Duty (VED).

3.44 In developing possible alternative capital allowance regimes for cars, it would also be necessary to consider:

- the consequences for the rules on the leasing or hiring of cars costing more than £12,000;

- what transitional rules would be needed;
- whether any reforms should apply for both corporation tax and income tax; and
- how any changes would affect businesses which provide cars for the disabled and the daily hire market.

Abortive capital expenditure

3.45 The August 2002 and 2003 consultation documents set out the case for an approach to capital expenditure and receipts, which would largely follow the accounts. This approach would have removed the capital/revenue divide and allowed expenditure, which is currently treated as capital for tax purposes to be relieved as it was written off in a company's accounts. One consequence of this approach would have been to provide relief for abortive capital expenditure, as the new accounts-based regime for intangible assets now does. Outside the intangibles regime (and also those for loan relationships and derivative contracts), while expenditure on successful acquisitions and disposals will generally be allowed in computing the capital gain on disposal of the asset, or taken into the capital allowances computation, there will often be no relief if no asset is ultimately acquired or no disposal made.

3.46 The Government recognises that business would like to see tax relief made available for abortive expenditure. But it is conscious of the difficulty in addressing this issue in the absence of any wider reform of the capital/revenue divide. One option would be to allow the abortive costs of acquiring and disposing of a capital asset to be relieved as a capital loss, where no relief is available under existing law. Consideration of this option would need to take into account any avoidance risks and also its interaction with the substantial shareholdings exemption. The Government's view is that, in principle, relief should not be available for abortive expenditure in connection with a shareholding that, if acquired, would subsequently be within the terms of the exemption.

3.47 Another might be to expand the range of abortive expenditure on plant and machinery that currently qualifies for relief under section 67 CAA. The Government would be interested in the views of business on the case and scope for change in this area in the absence of a wider reform of the capital/revenue divide.

Points on which comments are requested

3.48 What is companies' view of the broad approach set out at paragraphs 3.10 to 3.15 above?

3.49 What benefits do companies see arising from bringing the full amount of disposal proceeds on plant and machinery into charge through the capital allowances system?

3.50 Should a reformed capital allowances regime have special rules to defer profits on reinvestment (beyond the automatic deferral effect that would be achieved by pooling)?

3.51 What special reliefs or computational provisions within the current capital gains regime would need to be adapted within a reformed capital allowances regime (for example in the case of transfers within a group)?

3.52 What benefits does business see in the approach to buildings allowances suggested at paragraphs 3.27 to 3.35?

3.53 How should a building be defined for the purpose of any expanded buildings allowance?

3.54 How could the transition to any new regime be handled?

3.55 What are the implications for any reforms for the taxation of unincorporated businesses and for the interface between companies and the unincorporated?

3.56 What are the views of business on the possible options for the reform of expensive cars?

3.57 The Government would be interested in the views of business on the case and scope for change on abortive capital expenditure in the absence of a wider reform of the capital/revenue divide.

Chapter 4 – Leasing

4.1 The Government has considered the tax treatment of leased plant and machinery and has announced its decision to remove a distortion in the current system caused by the differing tax treatment of finance from different sources. Where a lease functions primarily as a financing transaction the Government proposes that an asset that is leased should be treated in broadly the same way as an asset that is purchased with a loan.

4.2 The Government's proposals, set out in this Technical Note, are based on the outline set out in the August 2003 consultation document and reflect comments made during the consultation and in subsequent constructive discussions with the leasing industry.

4.3 Draft legislation covering some of the core principles discussed in the chapter has been produced as an aide to detailed discussion and is included at Annex E with a technical commentary at Annex F. Legislation on these proposals will be included in Finance Bill 2006.

Current tax treatment of leases and outline of the new regime

4.4 Under the current rules, capital allowances are generally given to the legal owner of an asset. The legal owner may not coincide with the economic owner, who enjoys the risks and rewards of ownership. In particular, in certain leasing transactions (primarily finance leases) the two will not coincide: the lessor is the legal owner of the asset but the lessee is the economic owner, as recognised for finance leases in accounts drawn up using generally accepted accounting practice (GAAP).

4.5 The new regime will give capital allowances to the lessee rather than to the lessor, for certain leases. There will be corresponding changes to the tax treatment of lease rentals, to ensure that the lessor is no longer taxed on, and the lessee does not obtain a deduction for, the capital element of rentals.

4.6 The new regime will not affect existing leases and it will affect only leases which are essentially financing transactions. Moreover, the new rules will apply only to a subset of such leases, where the current tax treatment may influence the choice of finance (broadly, longer leases). The great majority of leases will be unaffected so that capital allowances will remain with the lessor.

4.7 In particular, the vast majority of leases to small and medium-sized enterprises will not be affected by the proposals. This addresses the concerns, expressed in consultation, that SMEs might be adversely affected by any change. It also means that the leasing industry will

continue to have opportunities to provide a wide range of value-adding services to an extensive customer base.

4.8 The Government remains committed to retaining mechanisms for delivering specifically targeted incentives, if necessary, through alternative mechanisms.

4.9 The changes will apply to unincorporated businesses as well as to companies.

Scope of changes

4.10 The new regime will apply only to leases that this document, and the draft legislation, refers to as “long funding leases”. The consultation process will inform the precise definition of long funding leases, as well as many other aspects of the new regime.

Funding leases

4.11 Generally accepted accounting practice classifies leases as “finance leases” or “operating leases”. While the proposed distinction between funding and non-funding leases has features in common with this accounting distinction, it is not considered appropriate to use the accounting classification for tax purposes, because it would not identify sufficiently accurately those leases which are essentially financing transactions.

4.12 The aim is to keep the definition as simple and practical as possible, consistent with achieving the aims of the policy.

4.13 The proposal is that a lease would be a funding lease only if, at the start of the lease, it satisfies one or more of the following criteria:

- it is treated as a finance lease under generally accepted accounting practice;
- the net present value of the minimum lease rentals (ignoring payments for ancillary services) is more than 75% of the market value of the asset;
- the minimum term of the lease is more than 50% of the expected remaining useful economic life of the asset; or
- the asset is of such a specialised nature that no other user of the asset could reasonably be expected.

4.14 Only a very small proportion of operating leases are likely to fall within these criteria.

4.15 The last three of the criteria are based on three of the criteria for identifying finance leases in International Accounting Standard 17, though with definite figures for the thresholds. It might therefore be appropriate for lessors and lessees to apply the definition independently as they do for accounting purposes. However, having lessors and lessees apply the criteria independently would lead to some difficulties, for example where an asset is subject to a lease and then one or more sub-leases at the same time. Therefore there might be a benefit to business if the lessor were to determine the tax status of a lease and then advise the lessee.

4.16 The Government would welcome comments on these criteria, and on whether the tax status of leases should be determined by the lessor and the lessee independently.

Defining long funding leases

4.17 Even if a lease were to meet one or more of the above criteria, it could be excluded from the new tax treatment if any tax effect on financing decisions is likely to be small.

4.18 The amount of tax benefit in a lease depends on the interaction between several factors, including the length of the lease, the residual value of the asset and the profile of the lease rentals. Whilst it may be possible to take all these factors into account there is an obvious attraction in using a relatively simple method to exclude leases from the new regime.

4.19 A substantial proportion of all leases are written for 4 years or less. Many of these short leases are unlikely to carry much of a tax benefit.

4.20 Where a lease is longer than about 4 years but less than about 6 years the tax timing benefit in the lease is small providing the lease rentals are broadly the same throughout the lease term and repay substantially all the capital (i.e. the lease has no significant residual value). Were there to be large variations in lease rentals, substantial tax timing advantages could be obtained such that they could affect a business's decision on the way it finances an asset.

4.21 Therefore leases could be excluded from the new regime where:

- the lease term is no more than 4 years; or

- the lease term is between 4 and 6 years but the lease rentals are broadly the same throughout the lease term, and any residual value implied by the terms of the lease does not exceed 5% of the initial value.

Suggestions for the way in which the lease rentals could be defined as "broadly the same" are contained in Annex A.

4.22 The result of identifying long funding leases in this way would be to exclude the vast majority of leases from the new regime. In particular, most leasing of vehicles and office equipment would be excluded. Examples of the effect on specific assets are set out in Annex A.

Assets leased more than once

4.23 Where assets are leased several times during their lives, right up to the end of their lives, the criteria would inevitably make the last lease in such an asset's life a funding lease, even though it might be a lease for a comparatively short proportion of the asset's total life.

4.24 To address concerns about this, the Government could introduce a rule that a lease would not be a funding lease when all of the following conditions were satisfied:

- the asset had been leased out before the current lease;
- in aggregate, the lease terms (excluding the current lease) exceeded 75% of the useful economic life of the asset;
- each of the leases before the current lease was a non-funding lease, or would have been had the current proposals been in force at the time.

Comments are invited on these conditions.

The new tax treatment

4.25 The new regime will tax a long funding lease on the basis of its commercial substance; that is, broadly as if it were a loan.

4.26 Where a lease is a long funding lease, the new tax treatment will depend on whether the lease is accounted for as a finance lease or as an operating lease.

Leases accounted for as finance leases

4.27 The accounting treatment of a finance lease recognises that it is commercially equivalent to a loan.

4.28 The new tax treatment will reflect that accounting treatment. It is proposed that the lessee, as the effective owner of the asset, will be able to claim capital allowances on an amount equal to the net present value of the minimum lease payments. This amount will be computed by following the accounting convention of discounting the minimum lease payments at the rate of interest implicit in the lease.

4.29 In addition to capital allowances, the lessee will be able to deduct amounts equivalent to interest contained within the lease rental payments. These latter amounts are the finance charges shown in accounts.

4.30 Correspondingly, only the finance charge elements in the lease rental payments will be taxable on the lessor.

4.31 It should be noted that the identification of amounts as equivalent to interest does not mean that the loan relationships legislation will apply to those amounts.

Leases accounted for as operating leases

4.32 As with leases accounted for as finance leases, an operating lessor will not be entitled to capital allowances on a leased asset where the lease is a long funding lease. The lessor will be taxed on, and the lessee will be able to deduct, amounts within the rental payments that correspond to interest.

4.33 It is necessary to design a mechanism to arrive at the deductible elements in rental payments. For leases accounted for as operating leases, this is not readily available from the accounts. A suggested way of obtaining these figures is set out in Annex A.

Changes of use

4.34 It will be necessary to deal with the situation where a lessor acquires an asset and uses it for other purposes, claiming capital allowances on it, before leasing it under a funding lease. A suggested way of dealing with this is set out in Annex A.

Ancillary services

4.35 Where leases fall to be treated as funding leases, whether accounted for as finance leases or as operating leases, payments for ancillary services such as maintenance will be excluded from the effect of the new rules. Such payments will be deductible for the lessee and taxable on the lessor, as they are now.

First year allowances

4.36 First year allowances would be available to a funding lessee at the same rate as if the lessee had bought the asset directly. An SME funding lessee, for example, would be entitled to first year allowances.

Impact of the new regime on various sectors

4.37 The new regime will affect only a small proportion of leases, mostly leases of large items for relatively long periods. However, the Government believes that the overall impact on investment would be minimal. Further information is given in the Regulatory Impact Assessment.

Shipping

4.38 The Government recognises that special issues arise for the shipping industry, particularly within the tonnage tax regime where capital allowances are not available. Therefore the Government will ensure that the new regime will not affect existing arrangements for leasing into tonnage tax.

Oil and gas

4.39 Special rules apply to profits from oil and gas extraction activities in the UK and on the UK continental shelf (ring fence trades). The leasing proposals would mean that first year allowances would become available to funding lessees that used plant and machinery in ring fence trades. The Government proposes to amend the special rules that apply to the deductibility of finance costs, to take account of the new rules for funding leases.

Consequential changes

Overseas leases

4.40 Some lessors would like to lease to overseas lessees. As a result of the reforms, the special rules for overseas leasing in sections 109 and 110 Capital Allowances Act 2001 (CAA) will no longer be needed for

leases written after the commencement date of the new regime. This change will facilitate the development of lessors' overseas business.

Allocation of expenditure to chargeable period

4.41 The amount of capital allowances available to a finance lessor in the period in which the leased asset is acquired is restricted by section 220 CAA. The Government has been asked to consider whether this anti-avoidance rule will continue to be needed under the new regime because much of the risk at which it is directed will be removed by the new regime. Removing the rule would also benefit business by reducing compliance costs.

4.42 However simply repealing section 220 would leave the Exchequer exposed to risks where the lessor company had a different accounting date from the rest of its group. One way forward might be to disapply section 220 only where the lessor company has the same accounting date as the rest of the group.

4.43 The Government would welcome comments on this proposal, particularly on whether a rule that applied only to companies with the same accounting date as the rest of the group would cause difficulties in practice.

Chains of leases

4.44 Chains of leases present special computational issues. The Government also needs to ensure that the regime does not allow potential avoidance opportunities. The Government would like to discuss these issues with interested parties before deciding on the best way to approach them.

Fixtures

4.45 The proposals would apply to leases of fixtures just as they would apply to movable plant and machinery, whether or not the land in question was leased.

4.46 Where plant was leased with land or with other assets under a single lease or a set of connected leases, a rule would be needed to apportion income and costs. The apportionment could be on a just and reasonable basis, similar to the rules in section 562 CAA (apportionment when property sold together).

Transitional issues

4.47 The new regime would not apply to a lease entered into before the commencement date. This basic rule would need to be supplemented by further transitional rules, ensuring that businesses are treated fairly and that the new regime is brought in effectively.

4.48 These transitional rules might need to cater for matters such as assets under construction and long term contracts. The Government would welcome comments on the issues involved.

Existing legislation relating to finance leases

4.49 This reform is a structural change to the way in which certain leased plant and machinery is taxed. The new regime will reduce the scope for future tax avoidance and, consequently, it will provide an opportunity to reconsider the anti-avoidance legislation relating to finance leases that is needed under the current regime. Some of this may become redundant, at least in part.

4.50 The Government will, of course, continue to act against avoidance within the existing leasing regime. It will also ensure there is sufficient anti-avoidance legislation to prevent abuse of the new regime. This might, for example, include amending existing legislation to apply to long funding leases, rather than to all finance leases.

4.51 The Government would welcome views on what legislation, if any, might be repealed or amended.

Points on which comments are requested

4.52 Is the proposed definition of a funding lease appropriate? Are there any elements in the proposed definition of a funding lease that might cause difficulties in practice? Would there be different difficulties from the perspective of lessor and lessee? It would be helpful to have examples of existing leases where the difficulty would (or is likely to) have arisen.

4.53 What are the advantages and disadvantages of allowing lessee and lessor to take an independent view on whether a lease is a long funding lease?

4.54 Would the proposed definition of long funding leases, including the length of leases covered, fulfil its purpose of excluding leases where

the tax treatment had no significant effect on the choice of method of finance?

4.55 Would the exemption for shorter leases be easy to apply in practice? Which is the best way to define lease rentals as ‘broadly the same’ over the life of the lease (Annex A, paragraphs A.4 to A.6)

4.56 Would the proposed rule concerning assets leased more than once achieve the objective? Is there a better way?

4.57 The Government would welcome comments on the detailed proposals for taxing both lessors and lessees in the new regime, distinguishing, between issues that apply where the lease is accounted for as a finance lease or as an operating lease.

4.58 What issues arise on chains of leases that would need to be addressed in the legislation?

4.59 The Government would welcome views on the approach to changes of use as set out in Annex A.

4.60 Would a “just and reasonable basis” be the best rule for apportioning income and costs when plant was leased with other assets under a single lease?

4.61 What issues around the commencement of the new rules would need to be addressed? Specific examples would be very helpful.

4.62 Apart from the overseas leasing and allocation rules (paragraphs 4.40 to 4.43), is there any other anti-avoidance legislation that could be amended or removed as a result of this reform?

Annex A: Further details and examples on leasing

Scope of proposal

Further details

A.1 The proposed definition of a funding lease is set out in paragraph 4.13 above and comments are invited.

A.2 Chapter 4 also explains why the Government thinks that it is appropriate to consider excluding shorter leases from the new regime. One way in which this could be achieved is to exclude all leases for less than 4 years and those leases of between 4 and 6 years where the lease rentals are broadly the same throughout the lease term. Leases with large terminal payments, for example, can contain substantial benefits and should be within the new regime.

A.3 If this method were to be adopted it would be necessary to define what is meant by lease rentals being 'broadly the same' throughout the lease term.

A.4 One way in which this could be achieved would be to apply the exclusion for leases of between 4 and 6 years only where total lease rentals falling due in any year could not differ from the total in any other by more than a specified percentage – say 10%.

A.5 Another approach might be to allow variations in lease rentals linked to particular variables such as interest rates. In either case, it might be appropriate to ignore a payment made at inception.

A.6 The Government would welcome comments on this approach. In particular would there be an advantage in increasing the 4-year and 6-year limits by a small amount (say to 51 and 75 months)? The Government would also welcome details of the way in which lease payments can vary over the life of a lease with a term of up to 6 years, together with comments on the proposals above.

Example 1

A.7 A 3-year lease of a car would probably not be a funding lease:

- it would not be classified as a finance lease under GAAP unless there were little or no residual value in the lease;
- the economic life of a car is generally well over 6 years so the 50% criterion would not be met;

- the criterion based on the net present value of lease rentals would not be met unless the residual value were more than about 30% of its original market value (the precise percentage would depend on the interest rate used in the lease, because that would affect the point at which the net present value of the minimum lease payments fell to 75% of the market value);

- and the specialised asset criterion would not be met in the case of a car that could be used by someone else (following commercially viable modification or re-spraying if necessary).

A.8 Even if a 3-year lease of a car were a funding lease under the above criteria, it would be outside the new regime by virtue of the exclusion for shorter leases.

Example 2

A.9 A 3-year full payout finance lease of a photocopier would be properly classified as a finance lease under GAAP and so it would be a funding lease. However it would be outside the new regime by virtue of the exclusion for shorter leases.

Example 3

A.10 An 8-year lease – with residual value – of a large passenger aircraft is unlikely to be a funding lease:

- it is unlikely to be classified as a finance lease under GAAP;

- its economic life is likely to exceed 16 years;

- the net present value of lease rentals is likely to be less than 75% of the aircraft's initial value;

- and it is difficult to see how it could be caught by the specialised asset test.

A.11 It would, of course, not be excluded as a shorter lease but that would not be needed in order to preserve the current tax treatment.

Proposed tax treatment

Leases accounted for as operating leases – further details

A.12 Under the new regime, taxing a funding lease that is accounted for as a finance lease should be a relatively straightforward process because it should be easy to pick up the appropriate figures from the accounts. Obtaining suitable figures is not as simple where the lease

is accounted for as an operating lease. What follows is one way in which this could be achieved and this method is followed in the draft legislation. Comments are invited on whether the approach could be improved.

A.13 At the start of a lease, the lessor would estimate the asset's residual value at the end of the lease. The difference between the asset's original value and its estimated residual value would be a proxy for depreciation of the asset. That difference could be spread evenly over the life of the lease. The interest element in each year's lease payments would then be the full payments, minus the amount of proxy depreciation allocated to that year.

A.14 At the end of the lease the lessor would be treated as acquiring the asset for capital allowance purposes for its residual value, as estimated at the start, plus any amounts that the lessor paid the lessee at that time. If the asset was then used for a purpose other than long funding leasing, or was sold, the capital allowance computation would flow as normal. If the asset was leased again under a long funding lease, there would be a disposal for the net present value of the minimum lease payments or for the market value, as appropriate.

A.15 For example, suppose that an asset with an expected economic life of 15 years was leased for ten years, for an annual rental of £115. The lessor might estimate that, over the ten years, the asset would fall in value from £1,000 to £250. The difference, £750, would be an allowable deduction in computing the lessor's income. Spread evenly over ten years this would mean that the lessor would be charged on gross rentals (as now) but less £75 a year, rather than less capital allowances. Thus the annual taxable income would be £40. The asset would be treated as acquired for capital allowance purposes by the lessor for £250 at the end of the lease.

A.16 This basic rule may need to be amended to take account of back-loaded leases.

A.17 In many straightforward cases the result would be the same as allowing the lessor to deduct depreciation in the accounts, but there would be no need for complex rules to cater for revaluations and changes in depreciation policy.

A.18 At the start of the lease the lessee would bring its estimate of the market value of the asset into its capital allowances computation as acquisition cost. The lessee's estimate might differ from the lessor's estimate. The lessee would get capital allowances as normal, based on that cost.

A.19 Because the lessee was entitled to capital allowances, only a proportion of its lease rentals could be allowed as a deduction for tax purposes. Following similar principles to those applying to lessors, the lessee would estimate the market value of the asset at the end of the lease. The difference between this figure and the estimated market value at inception would be disallowed over the life of the lease and the estimated market value at the end of the lease would be used as a capital allowance disposal value at the end of the lease. (In addition, any amounts that the lessee received from the lessor would be treated as capital allowances disposal proceeds, at the time when those amounts were determined.) As a result the lessee would get relief for all its rental payments, partly via capital allowances and partly by allowing a proportion of lease rentals.

A.20 For example, suppose that the lessee in the example of a ten-year lease above estimated an initial market value of £950 and a value at the end of the lease of £230. The fall in value would be £720, or £72 a year. The lessee would put £950 into its capital allowances computation at the start, and deduct disposal proceeds of £230 from that computation at the end. In each year of the lease, the lessee would also be entitled to a deduction each year on a straight-line basis for rental payments of £115 – £72 = £43.

A.21 The use of the lessor's estimates of market value in the lessor's computations of taxable income and depreciation allowances, and the lessee's estimates in the lessee's computations of allowable deductions and capital allowances, would ensure that, over time, the lessor would be taxed only on the profit made and the lessee would obtain a deduction for all expenditure.

Changes of use – further details

A.22 The proposed tax treatment of funding leases is set out above. However, as noted, it will be necessary to cater for a change of use where the asset had qualified for capital allowances in the hands of its legal owner but was then leased under a funding lease.

A.23 Where the lessor acquired the asset for another purpose and qualified for capital allowances, then later leased the asset under a long funding lease it would need to bring a disposal value into its capital allowance computation:

- where the lease was accounted for as a finance lease the disposal proceeds could be the net investment in the lease;
- where the lease was accounted for as an operating lease the disposal proceeds could be the market value at the start of the lease.

Annex B: Summary of responses to Aug 2003 consultation document

Schedular Reform

General comments

B.1 Respondents expressed the view that the current schedular rules, which stream various sources of income into separate cases and schedules, are complex, do not closely reflect economic reality and can lead to higher taxation because of limitations on loss relief. Respondents favoured options which gave the greatest flexibility to utilise losses, while also ensuring that foreign profits could continue to benefit from double taxation relief in the same way as now.

Types of pooling

B.2 Whilst most respondents favoured full pooling of all income and expenditure, others were of the view that there would still be substantial benefits for business, particularly SMEs, in the alternative option of pooling trading and letting income.

Loss relief

B.3 Respondents supported full pooling of losses - against all categories of current year profit and with indefinite carry forward. There was a general recognition that putting pre-commencement losses on all fours with post-commencement losses would be likely to have a significant Exchequer effect. But at the same time respondents were concerned that there should be appropriate mechanisms for relieving pre-commencement losses and a range of suggestions were made as to how this should be done. There was also concern that any revised loss rules should not inhibit groups from restructuring for commercial reasons.

Specific types of business

B.4 No specific issues were thought to arise on the North Sea upstream oil and gas trade, mutual trading or other specific sectors. However it was suggested that reform of the schedular system would necessitate a review of life assurance company taxation.

Administrative costs and savings

B.5 Respondents had mixed views on the likely levels of compliance savings, though some believed that fairly substantial benefits could arise through full pooling. Likewise, whilst some felt that greater benefits would arise for SMEs, others thought that larger companies would be the major beneficiaries of change. In terms of reduced

record keeping, respondents believed the extent of the reduction would be heavily reliant on the nature of the transitional provisions.

Trading and investment companies

B.6 A summary of responses on reform of management expenses was published in the December 2003 Technical Note *Corporation tax reform: the next steps* which contained draft clauses and commentary on management expenses, transfer pricing and thin capitalisation.

B.7 The other topic covered in responses on this strand of CT reform consultation was the idea of extending the substantial shareholdings exemption (SSE) to investment companies. This was supported by a number of respondents who saw it as providing greater certainty and fairness. Several commented that the current limitation of the exemption to trading companies increases compliance costs as groups need to review their trading status to ensure that they benefit from the exemption. And it was suggested that an extended SSE regime might permit more groups to restructure for commercial rather than tax reasons and would bring the UK exemption into line with foreign systems.

B.8 Some respondents argued that the Government's concerns over extending the exemption to non-trading investee companies could be addressed by incorporating specific anti-avoidance rules within any reforms and some said that it was more important to remove the trading requirement for the investee company than for the shareholder company. Others agreed with the Government's concerns about "money-box" companies but felt that those concerns could be met by targeted legislation to exclude closely held companies from an extended exemption.

Capital Assets

B.9 There was little enthusiasm for abandoning the capital gains/capital allowances computational approach and moving to a system which follows the accounts.

B.10 Respondents generally saw little to be gained from taxing capital profits in line with the accounting entries rather than under the current capital gains rules. They pointed out that some adjustments would still be needed (for example, as the consultation document recognised, to deal with unrealised gains on investment properties) and therefore believed that there was unlikely to be any reduction in complexity and compliance costs.

B.11 The current capital allowances regime for plant and machinery was seen as providing certainty, flexibility and equality of treatment.

Respondents cited pooling and the facility to disclaim allowances as being major advantages of the current system.

B.12 There was therefore little support for the proposal to replace plant and machinery writing down allowances with accounts depreciation.

B.13 Respondents were also concerned that economic incentives delivered through the capital allowances regime would either be lost or create a further level of complexity which negated any compliance saving made by following the accounts.

B.14 They saw the availability and cash-flow advantages of capital allowances as being a factor in investment decisions and suggested that a less favourable regime could reduce the attractiveness of the UK as a location for investment.

B.15 A further issue highlighted by business was the treatment of expensive cars. Respondents suggested that the current rules impose unnecessary compliance costs and that this was an area that should be a priority for modernisation.

B.16 The suggestion that relief could be extended to expenditure on all buildings used commercially was welcomed, particularly as the current allowance for industrial buildings was seen as outdated. Respondents expressed a preference for a fixed rate (rather than accounts-based) allowance - this was seen as fair and simple.

B.17 There was little enthusiasm for the proposal that an extended buildings allowance should replace plant and machinery allowances on fixtures in buildings such as lifts and air conditioning. And it was suggested using Land Law concepts to define the scope of a building allowance could increase complexity and lead to disputes between companies and the Revenue. But respondents accepted that the definition of a building for the purpose of any new allowance was an issue that would need to be explored.

B.18 On roll-over relief, responses were mixed. Some suggested that a form of roll-over relief should be extended to all real property; others considered that roll-over relief should be available on all assets where the proceeds are reinvested; while others argued that roll-over was unnecessary and should be abolished.

Shares

B.19 Respondents saw difficulties in bringing companies' shareholdings which are currently within the chargeable gains regime into an income regime that followed the accounting treatment.

B.20 There was concern that there were large numbers of shares which would fall to be accounted for on a mark to market basis and which did not currently benefit from the substantial shareholdings exemption. Respondents felt that revaluation gains on shares should not be taxed except where shares were traded on a recognised market. Otherwise gains on shares should continue to be taxed on a realisations basis. It was generally considered necessary to keep those provisions that operate around take-overs and re-constructions.

Transition

B.21 The transition to a new capital assets regime was seen as a potential source of complexity and unfairness. A long transition was generally rejected because of the need to operate two systems and keep two lots of records for many years. But respondents thought that a short transition might involve costly and time-consuming valuations.

B.22 Some suggested that difficulties could be alleviated by rebasing at commencement or by spreading transitional gains and losses over a period. However, the main concern was the preservation of losses brought forward. These could be preserved by enhanced carry-back provisions and/or a 'shadow' regime.

Leasing Reform

General Comments

B.23 Most respondents suggested that there would be a major impact on the leasing industry. Many respondents made the point that finance leasing can reduce the cost of capital for non-taxpayers and for SMEs (for whom cash-flow was also particularly important). Respondents also raised the effect of reform on PFI projects, local authorities and the voluntary sector.

B.24 Some respondents said that the changes would be of some benefit, particularly in opening up opportunities for overseas leasing.

B.25 Many respondents saw the definition of a funding lease as a significant issue and there was a common request that the definition be considered very carefully, particularly to ensure that genuine operating leases did not count as funding leases.

Sectoral issues

B.26 The rail and aviation industries were concerned that the proposals could affect the costs of funding. Some respondents wanted to preserve lessors' ability to claim capital allowances.

B.27 The shipping industry's main concern was to ensure the preservation of the benefits of the tonnage tax regime – in particular that, subject to a cap, capital allowances are available on ships leased to tonnage tax companies.

B.28 The response to the proposals by vehicle lessors was mixed, with one major manufacturer welcoming the proposals, whilst others were concerned that the proposals would increase the lease rentals payable by lessees.

ANNEX C - SCHEDULAR REFORM

Draft Clauses and Schedule

CONTENTS

Corporation tax: income and assessments

1 Income and assessments for the purposes of corporation tax

New Case I of Schedule D

2 Corporation tax on profits of company's operating business
3 The new Case I of Schedule D
4 Power to provide for amounts to fall within Case I or Case VI of Schedule D
5 Supplemental and consequential provision

Miscellaneous and supplementary provisions

6 Power to make consequential amendments

Schedule 1 — Corporation tax: Case I of Schedule D: supplementary provisions
Part 1 — Amendments of ICTA
Part 2 — Amendments of Chapter 2 of Part 4 of FA 1996
Part 3 — Amendments of FA 1998
Part 4 — Amendments of Schedule 26 to FA 2002
Part 5 — Amendments of Schedule 29 to FA 2002

Corporation tax: income and assessments

1 Income and assessments for the purposes of corporation tax

In ICTA, for section 9 (computation of income: application of income tax principles) substitute—

“9 Income and assessments for the purposes of corporation tax

(1) For the purposes of corporation tax, income shall be computed, and the assessment shall be made—
(a) under Schedule D and the Cases of that Schedule, and
(b) in accordance with the provisions applicable to that Schedule and those Cases.

(2) To arrive at the total profits for the purposes of corporation tax, aggregate—
(a) the amounts computed under Schedule D and the Cases of that Schedule for the several sources of income, if more than one; and
(b) any amount to be included in respect of chargeable gains.

(3) Subsection (2) above is subject to the provisions of the Corporation Tax Acts.”.

New Case I of Schedule D

2 Corporation tax on profits of company’s operating business

(1) Corporation tax shall not be chargeable under Schedule A for any accounting period beginning on or after <**DATE**>.

(2) In ICTA, section 18 (Schedule D) is amended as follows.

(3) In subsection (1), in Schedule D,—
(a) before paragraph (a) insert—
“(aa) the profits of the whole of the business carried on (whether wholly or partly in the United Kingdom or wholly or partly outside the United Kingdom) by a company, whether or not resident in the United Kingdom,”;
(b) in paragraph (a) (annual profits or gains arising or accruing etc)—
(i) in the opening words, omit “or gains”;
(ii) omit sub-paragraph (ii) (income from trade or profession carried on by UK resident);

(iii) in sub-paragraph (iii) (company not resident in UK) omit "or from any trade, profession or vocation exercised within the United Kingdom";

(c) for paragraph (b) (interest etc not charged under Schedule A or ITEPA 2003 etc) substitute—

"(b) all interest of money, annuities and other annual profits or gains not specially exempted from tax,";

(d) after the end of the paragraphs insert—

"but, in the case of a company which is not resident in the United Kingdom, this Schedule (and the Cases set out in subsection (3) below and section 18A) are subject to section 11."

(4) In subsection (2) (tax to be charged under the Cases set out in subsection (3)) after "set out in subsection (3) below" insert "(and section 18A)".

(5) In subsection (3) (the Cases of Schedule D)—

(a) for Cases I and II substitute—

"Case I: this Case is set out in section 18A (corporation tax in respect of the profits of the whole of the business carried on (whether wholly or partly in the United Kingdom or wholly or partly outside the United Kingdom) by a company, whether or not resident in the United Kingdom);";

(b) For Cases III and IV substitute—

"Case III: tax in respect of—

(a) profits and gains which, as profits and gains arising from loan relationships, are to be treated as chargeable under this Case by virtue of Chapter 2 of Part 4 of the Finance Act 1996;

(b) any annuity or other annual payment which—

(i) is payable (whether inside or outside the United Kingdom and whether annually or at shorter or longer intervals) in respect of anything other than a loan relationship; and

(ii) is not a payment chargeable under Case I;

(c) any discount arising otherwise than in respect of a loan relationship and not being income chargeable under Case I;";

(c) For Case V substitute—

"Case V: tax in respect of income arising from possessions out of the United Kingdom not being—

(a) income chargeable under Case I, or

(b) income falling within paragraph (a) of Case III;";

(d) for Case VI substitute—

"Case VI: tax in respect of any profits not falling under any other Case of Schedule D.".

(6) Omit subsection (3A) (the corporation tax version of Case III, given effect with modifications by this section, and corporation tax modifications of Case V, dealt with similarly).

(7) In subsection (3B) (construction of certain references) omit from "Case IV" to "and in".

(8) In subsection (4) (other provisions directing tax to be charged under Schedule D or a Case set out in subsection (3)) after "set out in subsection (3) above" insert "(or section 18A)".

(9) For subsection (4A) (application etc of subsections (1) to (4)) substitute—

"(4A) Subsections (1) to (4) apply for the purposes of corporation tax only.".

3 The new Case I of Schedule D

In ICTA, after section 18 (Schedule D) insert—

"18A Case I of Schedule D

The Case referred to as Case I of Schedule D is as follows—

"Case I: corporation tax in respect of the profits of the whole of the business (the "operating business") carried on (whether wholly or partly in the United Kingdom or wholly or partly outside the United Kingdom) by a company, whether or not resident in the United Kingdom.

The following supplementary provisions have effect—

The profits of a company's operating business: excluded amounts

1. In computing for the purposes of corporation tax the profits of the operating business carried on by a company, leave out of account any amounts which are excluded amounts for the purposes of this Case.

The excluded amounts

2.—(1) The amounts which are excluded amounts for the purposes of this Case are—

(a) except as otherwise provided by the Corporation Tax Acts, the dividends and other distributions of a company resident in the United Kingdom (see section 208);

(b) foreign dividends, other than those which, had the company been within the charge to income tax instead of corporation tax, would have been brought into account in computing the profits of a trade carried on by the company;

(c) non-trading credits and non-trading debits under Chapter 2 of Part 4 of the Finance Act 1996 (loan relationships);

(d) credits and debits which, by virtue of paragraph 14(3) of Schedule 26 to the Finance Act 2002 (derivative contracts), fall to be brought into account as if they were non-trading credits or non-trading debits falling to be brought into account for the purposes of Chapter 2 of Part 4 of the Finance Act 1996 in respect of loan relationships of the company;

(e) non-trading credits and non-trading debits under Schedule 29 to the Finance Act 2002 (intangible fixed assets) (see paragraph 34(1) of that Schedule);

(f) capital allowances in respect of plant or machinery used for the purpose of a qualifying activity falling within section 15(1)(g) of

the Capital Allowances Act (management of a company with investment business);

(g) charges falling to be given effect under section 253(3) of the Capital Allowances Act in respect of any such plant or machinery;

(h) profits or losses arising from the occupation of land situated in the United Kingdom which comprises woodland or is being prepared for use for forestry purposes, other than profits or losses arising from the cultivation of short rotation coppice within the meaning of section 154 of the Finance Act 1995;

(i) amounts in respect of expenses that satisfy the condition in sub-paragraph (2) below.

(2) The condition is that—

(a) on the assumption that they do not fall to be brought into account under this Case, the expenses would be deductible under section 75 (expenses of management), and

(b) had the company been within the charge to income tax, instead of corporation tax, the expenses would not have been deductible in computing the profits of any trade or property business carried on by the company.

(3) In this paragraph—

"foreign dividends" means dividends or other distributions payable out of or in respect of the stocks, funds, shares or securities, or any other interest of a member, of a body of persons not resident in the United Kingdom;

"property business" has the same meaning as in ITTOIA 2005 (see section 263(5) of that Act).

Ventures in the nature of trade

3. Any venture in the nature of trade by a company is to be regarded as part of its operating business.

Transactions for the exploitation of land as a source of rents etc

4. To the extent that any transaction is entered into by a company for the exploitation, as a source of rents or other receipts, of any estate, interest or rights in or over land in the United Kingdom or elsewhere, it is to be regarded as entered into in the course of the company's operating business.

Offices and employments

5.—(1) Any office or employment held by a company is to be regarded as part of its operating business.

(2) In this paragraph—

"employment" includes in particular—

(a) any employment under a contract of service;

(b) any employment in the service of the Crown;

"office" includes in particular any position which has an existence independent of the person who holds it and may be filled by successive holders.

Requirement for expectation of profit or exercise of statutory functions

6.—(1) For the purpose of computing the profit or loss of a company's operating business for any accounting period, so much of that business as does not fall within sub-paragraph (2) below shall be treated as excluded from that business.

(2) A company's operating business falls within this sub-paragraph only to the extent that it is carried on—

(a) with a view to making a profit (but see also sub-paragraph (3)), or

(b) in the exercise of statutory functions (see sub-paragraph (5)).

(3) For the purposes of this paragraph—

(a) if a company's operating business, or a part of that business, is carried on so as to afford a reasonable expectation of profit, it is treated as carried on with a view to making a profit, and

(b) any part of the business which is not itself carried on with a view to making a profit (and which does not fall within paragraph (a) above) but which is carried on with a view to facilitating the making of profits in another part of the business shall be treated as carried on with a view to making a profit.

(4) If there is a change in the manner in which a company's operating business or a part of that business is carried on, it is treated for the purposes of sub-paragraph (2)(a) above as having been carried on throughout an accounting period in the way in which it was being carried on by the end of the period.

(5) In sub-paragraph (2)(b) above, "statutory functions" means functions conferred by or under any enactment (including an enactment contained in a local or private Act).

(6) In sub-paragraph (5) above, "enactment" includes any provision contained in—

(a) an Act of the Scottish Parliament;

(b) Northern Ireland legislation;

(c) subordinate legislation, within the meaning of the Interpretation Act 1978 (see section 21 of that Act).".

4 Power to provide for amounts to fall within Case I or Case VI of Schedule D

(1) For the purposes of corporation tax, the Treasury may by regulations make provision for or in connection with any of the following—

(a) requiring amounts of a prescribed description to be brought into account in computing the profits of a company's operating business instead of being charged under Case VI of Schedule D;

(b) requiring amounts of a prescribed description to be charged under Case VI of Schedule D instead of being brought into account in computing the profits of a company's operating business;

(c) providing for a prescribed amount to be brought into account in computing the profits of a company's operating business in some circumstances but to be charged under Case VI of Schedule D in other circumstances;

(d) varying the description, in any enactment, of any amount, or of the circumstances in which any amount arises, so that the amount falls to be brought into account in computing the profits of a company's operating business or falls to be charged under Case VI of Schedule D.

(2) The provision that may be made by regulations under this section includes provision for or in connection with—
  (a) substituting references to a company's operating business for references to trade, to property business or to overseas property business;
  (b) treating a company which has ceased to carry on any operating business as if it continued to carry on such a business.

(3) The provision that may be made by regulations under this section includes provision—
  (a) amending any enactment, or
  (b) applying any provision of any enactment with or without modifications.

(4) Any power to make regulations under this section includes power—
  (a) to make different provision for different cases;
  (b) to make incidental, consequential, supplemental, or transitional provision or savings.

(5) In this section—
"enactment" includes any provision comprised in subordinate legislation;
"prescribed" means specified, or of a description specified, in regulations under this section;
"subordinate legislation" has the same meaning as in the Interpretation Act (see section 21 of that Act).

5 Supplemental and consequential provision

Schedule 1 (which contains supplemental and consequential provisions) shall have effect.

Miscellaneous and supplementary provisions

6 Power to make consequential amendments

(1) The Treasury may by regulations make such amendments, repeals or revocations in any enactment (including an enactment amended by this Act) as appear to them to be appropriate in consequence of any provision made by sections 1 to 4 and Schedule 1.

(2) The provision that may be made by regulations under this section includes provision for or in connection with—
  (a) substituting references to a company's operating business for references to trade, to property business or to overseas property business;
  (b) treating a company which has ceased to carry on any operating business as if it continued to carry on such a business.

(3) Any power to make regulations under this section includes power—
  (a) to make different provision for different cases, and
  (b) to make incidental, consequential, supplemental, or transitional provision or savings.

(4) In this section—

"enactment" includes any provision comprised in subordinate legislation;

"subordinate legislation" has the same meaning as in the Interpretation Act (see section 21 of that Act).

SCHEDULES

SCHEDULE 1

Section 5

CORPORATION TAX: CASE I OF SCHEDULE D: SUPPLEMENTARY PROVISIONS

PART 1

AMENDMENTS OF ICTA

Introductory

1 ICTA is amended in accordance with the following provisions of this Part of this Schedule.

Meaning of "trade" in certain provisions

2 (1) Section 6 (the charge to corporation tax and exclusion of income tax and capital gains tax) is amended as follows.

(2) In subsection (4), omit paragraph (b) ("trade" to include vocation, office or employment in certain provisions).

Basis of, and periods for, assessment

3 (1) Section 12 (basis of, and periods for, assessment) is amended as follows.

(2) In subsection (3) (accounting period to end for purposes of corporation tax on first occurrence of certain events) for paragraph (c) (beginning or ceasing to trade etc) substitute—

"(c) the company beginning or ceasing to carry on an operating business or to be, in respect of its operating business, within the charge to corporation tax;".

Abolition of Schedule A

4 Section 15 (Schedule A) shall cease to have effect.

Farming and other commercial occupation of land (except woodlands)

5 Section 53 (farming etc) shall cease to have effect.

Mines, quarries and other concerns

6 Section 55 (profits arising from mines etc to be charged to tax under Case I of Schedule D) shall cease to have effect.

Basis of assessment etc

7 (1) Section 70 (basis of assessment etc) is amended as follows.

(2) Omit subsection (1) (computation under the Cases of Schedule D to be on full amount of profits etc).

(3) Omit subsection (2) (computation of income from trade or vocation chargeable under Case V of Schedule D).

Case V income from land outside the United Kingdom: corporation tax

8 Section 70A (Case V income from land outside the UK: corporation tax) shall cease to have effect.

Apportionment etc of company's profits for purposes of Schedule D

9 For section 72 (apportionments etc for the purposes of Cases I, II and VI of Schedule D) substitute—

"72 Apportionment etc of company's profits for purposes of Schedule D

(1) This section applies if an accounting period of a company does not coincide with a period of account of the company.

(2) Any of the following steps may be taken if they are necessary to arrive at the profits of the accounting period chargeable under Schedule D or any of the Cases of that Schedule—

(a) apportioning the profits or losses of a period of account to the parts of that period falling in different accounting periods;

(b) adding the profits or losses of a period of account (or part of a period of account) to profits or losses of other periods of account (or parts).

(3) The steps must be taken by reference to the number of days in the period concerned.

(4) But the company may use a different way of measuring the length of the periods concerned if—

(a) it is reasonable to do so, and

(b) the way of measuring the length of periods is used consistently by the company for the purposes of Schedule D.".

Receipts and expenditure of a capital nature not to be brought into account

10 In Chapter 5 of Part 4 (computational provisions relating to the Schedule D charge) at the beginning (before the heading "*Deductions*") insert—

"Capital receipts and capital expenditure

73A Capital receipts

(1) Items of a capital nature must not be brought into account as receipts in calculating the profits of a company's operating business for the purposes of corporation tax.

(2) Subsection (1) above is subject to the provisions of the Corporation Tax Acts.”.

73B Capital expenditure

(1) In calculating the profits of a company’s operating business for the purposes of corporation tax, no deduction is allowed for items of a capital nature.

(2) Subsection (1) above is subject to the provisions of the Corporation Tax Acts.”.

Expenses not wholly and exclusively for operating business, and unconnected losses

11 For section 74 (general rules as to deductions not allowable) substitute—

“74 Expenses not wholly and exclusively for operating business, and unconnected losses

(1) In calculating the profits of a company’s operating business for the purposes of corporation tax, no deduction is allowed for—
  (a) expenses not incurred wholly and exclusively for the purposes of that business, or
  (b) losses not connected with or arising out of that business.

This subsection is subject to the provisions of the Corporation Tax Acts.

(2) If an expense is incurred for more than one purpose, this section does not prohibit a deduction for any identifiable part, or any proportion, of the expense which is incurred wholly and exclusively for the purposes of the company’s operating business.”.

Expenditure on preserving or changing the ownership of shares or on the issue of shares

12 After section 85B insert—

“85C Expenditure in connection with share issues, take-over bids etc

For the purposes of corporation tax, expenditure incurred by a company—
  (a) in an endeavour to preserve, or to secure a change in, the ownership of shares issued by the company, or
  (b) in issuing shares,

is not expenditure incurred by the company for the purposes of its operating business.

Restriction of deductions in respect of certain debts

13 (1) Section 88D is amended as follows.

(2) In subsection (2) (restriction in calculating profits of a company’s trade) for “trade”, in each place where it occurs, substitute “operating business”.

(3) Omit subsection (4) (meaning of “trade”).

Replacement and alteration of operating business tools

14 After section 91C insert—

“91D Replacement and alteration of operating business tools

(1) This section applies if—

(a) expenses are incurred by a company on replacing or altering implements, utensils, or articles, used for the purposes of the company’s operating business, and

(b) a deduction for the expenses would not otherwise be allowable in calculating the profits of the operating business for the purposes of corporation tax because (and only because) they are items of a capital nature.

(2) In calculating the profits of the operating business for those purposes, a deduction is allowed for the expenses.”.

Sums recovered under insurance policies etc

15 After section 93 insert—

“93A Sums recovered under insurance policies etc

(1) This section applies if—

(a) a deduction is allowed for a loss or expense in calculating the profits of a company’s operating business for the purposes of corporation tax,

(b) the company recovers a sum under an insurance policy or a contract of indemnity in respect of the loss or expense, and

(c) the sum is not of a revenue nature.

(2) The sum is brought into account as a receipt in calculating the profits of the company’s operating business for the purposes of corporation tax (but only up to the amount of the deduction).”.

Tied premises: receipts and expenses treated as those of a trade

16 Section 98 (tied premises etc: Schedule A and Case I of Schedule D) shall cease to have effect.

Transfers of trading stock

17 After section 99 insert—

“Profits of company’s operating business: transfers of trading stock: introductory

99A Meaning of “trading stock” in sections 99B to 99E

(1) In sections 99B to 99E “trading stock”, in relation to a trade, means anything (whether land or other property)—

(a) which is sold in the ordinary course of the trade, or

(b) which would be so sold if it were mature or its manufacture, preparation or construction were complete.

(2) It does not include—
  (a) materials used in the manufacture, preparation or construction of any such thing,
  (b) any services performed in the ordinary course of the trade, or
  (c) any article produced, or any material used, in the performance of any such services.

Transfers of trading stock between trade and company

99B Trading stock appropriated by company

(1) This section applies if trading stock of a trade carried on by a company is appropriated by the company for any other purpose.

(2) In calculating the profits of the company's operating business for the purposes of corporation tax—
  (a) the amount which the stock appropriated would have realised if sold in the open market at the time of the appropriation is brought into account as a receipt, and
  (b) the value of anything in fact received for it is left out of account.

(3) The receipt is treated as arising on the day of the appropriation.

99C Trading stock supplied by company

(1) This section applies if something that—
  (a) belongs to a company carrying on a trade, but
  (b) is not trading stock of the trade,

becomes trading stock of the trade.

(2) In calculating the profits of the company's operating business for the purposes of corporation tax, the cost of the stock is taken to be the amount which it would have realised if sold in the open market at the time it became trading stock of the trade.

(3) The cost is treated as being incurred on the date it became trading stock of the trade.

Other disposals and acquisitions not made in the course of trade

99D Disposals not made in the course of trade

(1) This section applies if—
  (a) trading stock of a trade carried on by a company is disposed of otherwise than in the course of trade, and
  (b) section 99B does not apply.

(2) In calculating the profits of the company's operating business for the purposes of corporation tax—
  (a) the amount which the stock disposed of would have realised if sold in the open market at the time of the disposal is brought into account as a receipt, and
  (b) any consideration obtained for it is left out of account.

(3) The receipt is treated as arising on the date of the disposal.

99E Acquisitions not made in the course of trade

(1) This section applies if—

(a) trading stock of a trade carried on by a company has been acquired otherwise than in the course of trade, and

(b) section 99C does not apply.

(2) In calculating the profits of the company's operating business for the purposes of corporation tax, the cost of the stock is taken to be the amount which it would have realised if sold in the open market at the time of the acquisition.

(3) The cost is treated as being incurred on the date of the acquisition.".

Rent etc payable in connection with mines, quarries and similar concerns

18 Section 119 (rent in connection with mines etc chargeable under Schedule D) shall cease to have effect.

Rent etc payable in respect of electric line wayleaves

19 Section 120 (wayleave rental: Schedules A and D) shall cease to have effect.

Company beginning or ceasing to be within charge in respect of its operating business

20 For section 337 (company beginning or ceasing to carry on trade) substitute—

"337 Company beginning or ceasing to be within the charge to corporation tax in respect of its operating business

(1) This section applies where a company at any time begins or ceases to be within the charge to corporation tax in respect of its operating business.

(2) The company's income shall be computed as if that were the commencement or, as the case may be, the discontinuance of the operating business, whether or not the operating business is in fact commenced or discontinued.".

Letting of furnished holiday accommodation treated as trade for certain purposes

21 Section 503 (furnished holiday lettings: treatment as trade rather than Schedule A business) shall cease to have effect.

Deductions not to be allowed in computing profits or gains

22 Section 817 (which is of no further practical utility for corporation tax) shall cease to have effect.

Interpretation

23 (1) Section 832 (interpretation of the Tax Acts) is amended as follows.

(2) In subsection (1), insert the following definition at the appropriate place—

"operating business" shall be construed in accordance with Case I of Schedule D (see section 18A);".

(3) Omit subsection (4) (which relates to section 9 and the former express application of income tax law for certain purposes of corporation tax).

PART 2

AMENDMENTS OF CHAPTER 2 OF PART 4 OF FA 1996

Introductory

24 Chapter 2 of Part 4 of FA 1996 (loan relationships) is amended in accordance with the following provisions of this Part of this Schedule.

Taxation of loan relationships

25 (1) Section 80 is amended as follows.

(2) In subsection (2) (company party to loan relationship for the purposes of a trade carried on by it)—
- (a) after "for the purposes of a trade" insert "or property business", and
- (b) for "profits of the trade" substitute "profits of the company's operating business".

Method of bringing amounts into account

26 (1) Section 82 is amended as follows.

(2) For subsection (2) (trading credits and debits) substitute—

"(2) To the extent that, in any accounting period, a loan relationship of a company is one to which it is a party for the purposes of a trade or property business carried on by it, the credits and debits given in respect of that relationship for that period shall be treated (according to whether they are credits or debits) either—
- (a) as receipts that fall to be brought into account in computing the profits of the company's operating business for that period, or
- (b) as expenses that fall to be brought into account in computing those profits.".

Interest, and exchange gains and losses, on debts etc not arising from the lending of money

27 (1) Section 100 is amended as follows.

(2) In subsection (5) (test for trading or non-trading debits and credits under the section: interest) in each of paragraphs (a) and (b), after "trade" insert "or property business".

(3) In subsection (6) (test for trading or non-trading debits and credits under the section: exchange gains and losses) in each of paragraphs (a) and (b), after "trade" insert "or property business".

(4) In subsection (12) (condition for falling within subsection (11)(a))—
- (a) in paragraph (a), for the words from "a trade," to "the Taxes Act 1988)" substitute "a trade or property business";
- (b) in paragraph (b), for "the trade, Schedule A business or overseas property business" substitute "the trade or property business".

Interpretation

28 (1) Section 103 (interpretation of the Chapter) is amended as follows.

(2) In subsection (1) (defined expressions) insert the following definition at the appropriate place—

"“property business” has the meaning given by section 103A below;".

(3) For subsection (2) (the test for a company being party to a creditor relationship for the purposes of a trade) substitute—

"(2) For the purposes of this Chapter a company shall be taken to be a party to a creditor relationship—

(a) for the purposes of a trade carried on by that company, only if it is a party to that relationship in the course of activities forming an integral part of that trade, or

(b) for the purposes of a property business carried on by that company, only if it is a party to that relationship in the course of activities forming an integral part of that business.".

(4) In subsection (3) (mutual trading etc deemed not to constitute whole or part of a trade) at the end add "or of a company's operating business".

Meaning of "property business"

29 After section 103 insert—

"103A Meaning of "property business"

(1) For the purposes of this Chapter a company's property business consists of every part of the company's operating business—

(a) which is carried on for generating income from land, whether in the United Kingdom or elsewhere, and

(b) the profits and losses of which fall to be brought into account in charging the company to corporation tax under Case I of Schedule D.

(2) In this section "generating income from land" means exploiting an estate, interest or right in or over land as a source of rent or other receipts.

(3) "Rents" includes payments by a tenant for work to maintain or repair leased premises which the lease does not require the tenant to carry out.

(4) "Other receipts" includes—

(a) payments in respect of a licence to occupy or otherwise use land;

(b) payments in respect of the exercise of any other right over land;

(c) rentcharges and other annual payments reserved in respect of, or charged on or issuing out of, land.

(5) For the purposes of this section a right to use a caravan or houseboat at only one location is treated as a right deriving from an estate or interest in land.

(6) "Lease" includes—
(a) in England and Wales or Northern Ireland, an agreement for a lease,
(b) in Scotland, an agreement (including missives of let not constituting a lease) under which a lease is to be executed,
(c) any tenancy,
but does not include a mortgage or heritable security.

(7) "Premises" includes land.

(8) If a provision of this section—
(a) applies to a property business or land to any extent outside the United Kingdom, but
(b) is expressed by reference to a concept of the law of a part of the United Kingdom,
then, in relation to that business or land, the provision is to that extent to be read so as to produce the result most closely corresponding with that produced by the provision in relation to a property business or land in the United Kingdom.".

Carry forward of deficit to succeeding accounting periods

30 (1) In Schedule 8 (loan relationships: claims etc relating to deficits) paragraph 4 is amended as follows.

(2) For sub-paragraph (6) (definition of "non-trading profits") substitute—

"(6) In this paragraph "non-trading profits", in relation to a company, means profits of the company (of whatever description) which are not chargeable to corporation tax under Case I of Schedule D.".

PART 3

AMENDMENTS OF FA 1998

Introductory

31 The FA 1998 is amended in accordance with the following provisions of this Part of this Schedule.

Computation of profits trade, profession or vocation

32 (1) Section 42 (computation of profits of trade, profession or vocation) is amended as follows.

(2) In subsection (1) (computation of certain profits in accordance with generally accepted accounting practice) for "Case I or II of Schedule D the profits of a trade, profession or vocation" substitute "Case I of Schedule D the profits of a company's operating business".

(3) The side-note to the section accordingly becomes "Computation of profits of company's operating business".

(4) In consequence of the amendments made by this Part, the italic cross-heading immediately preceding the section becomes "Computation of profits of company's operating business".

Minor provisions about computations

33 (1) Section 46 (minor and consequential provisions about computations) is amended as follows.

(2) In subsections (1) and (2), for "a trade, profession or vocation" substitute "a company's operating business".

PART 4

AMENDMENTS OF SCHEDULE 26 TO FA 2002

Introductory

34 Schedule 26 to the FA 2002 (derivative contracts) is amended in accordance with the following provisions of this Part of this Schedule.

Method of bringing amounts into account

35 (1) Paragraph 14 is amended as follows.

(2) For sub-paragraph (2) (trading credits and debits) substitute—

"(2) To the extent that, in any accounting period, a derivative contract of a company is one to which the company is party for the purposes of a trade or property business carried on by it, the credits and debits given in respect of that contract for that period shall be treated (according to whether they are credits or debits) either—
(a) as receipts that fall to be brought into account in computing the profits of the company's operating business for that period, or
(b) as expenses that fall to be brought into account in computing those profits.".

(3) After sub-paragraph (4) insert—

"(5) In this section "property business" has the same meaning as in Chapter 2 of Part 4 of the Finance Act 1996 (loan relationships) (see section 103A of that Act).".

PART 5

AMENDMENTS OF SCHEDULE 29 TO FA 2002

Introductory

36 Schedule 29 to the FA 2002 (intangible fixed assets) is amended in accordance with the following provisions of this Part of this Schedule.

Asset held for purposes of trade

37 (1) Paragraph 31 is amended as follows.

(2) In—
(a) paragraph (a),
(b) paragraph (b), and

(c) the words following paragraph (b),

for “trade” substitute “company’s operating business”.

Asset held for purposes of property business

38 (1) Paragraph 32 is amended as follows.

(2) In sub-paragraph (2), in—

(a) paragraph (a),

(b) paragraph (b), and

(c) the words following paragraph (b),

for “business” substitute “company’s operating business”.

(3) For sub-paragraphs (2) to (4) (meaning of “property business”) substitute—

“(2) A “property business” has the same meaning as in Chapter 2 of Part 4 of the Finance Act 1996 (loan relationships) (see section 103A of that Act).”.

Assets held for purposes of mines, transport undertakings, etc

39 Paragraph 33 (which is superseded) shall cease to have effect.

Annex D: Schedular Reform - technical commentary on the draft legislation

Introduction

D.1 The draft legislation in Annex C gives an indication of how the core statutory provisions of the regime described in Chapter 2 might look. They cover the definition of the new operating business source and its basic computational rules. This commentary discusses specific points on which observation would be particularly welcome.

D.2 The draft clauses do not deal with:

- the rules whereby losses arising from the new operating business source are relieved (outlined in paragraphs 2.25 to 2.31 of Chapter 2);
- the commencement/transitional provisions (2.32);
- consequential changes to corporation tax law (2.23 and 2.39-40);
- the special rules needed for particular types of business (2.34).

Some of the necessary provisions could be dealt with by secondary legislation (see paragraph D.42 below) but many would be matters for primary legislation.

D.3 The new operating business source is accommodated in a new expanded Case I of Schedule D, the scope of which would be defined in a new section 18A of the Income and Corporation Taxes Act 1988 (ICTA). That source would in essence comprise the whole of a company's commercial activities excluding incomings and outgoings relating to investment business. The principal computational rules in Chapter 5 of Part 4 of ICTA for trading profits are adapted to apply them to the operating business computation.

D.4 The proposed Income Tax (Trading and Other Income) Act (ITTOIA) contains a Schedule of amendments to existing tax law to reflect the fact that the existing rules, covering the ground, which is the subject matter of the Act, will no longer apply for income tax once it takes effect. That is expected to be from April 2005. The draft legislation in Annex C has therefore been prepared on the assumption that the amendments to existing law in the proposed ITTOIA (see http://newinternet.inrev.gov.uk/rewrite/ for latest version) will already be in place.

D.5 Where the proposed core rules for computing the profits from the operating business source correspond to provisions relating to trading income in the proposed ITTOIA its wording has, where possible, been borrowed. And provisions found to be obsolete as a result of research carried out as part of the Rewrite exercise would be repealed.

Clause 1

D.6 This clause replaces section 9 of ICTA, which currently sets out the requirement to aggregate income and gains of different types in arriving at the profits chargeable to corporation tax. Current law also explicitly requires income tax law and practice to be applied for the purposes of corporation tax in computing the income from sources chargeable to income tax.

D.7 The replacement section deals only with the first element, aggregation. The reasons for dropping the second element are explained below. The current provisions have their origin in the 1965 Finance Act when corporation tax was first introduced and drew extensively on existing income tax law and practice for its computational rules. Once the ITTOIA is enacted, the computational rules in ICTA governing the computation of income will apply only for corporation tax. Furthermore, if schedular reform proceeds, companies' principal source of income, the operating business, will not be one, which exists for income tax. As a result, the current rule applying income tax law and practice generally for corporation tax purposes would have, at best, an uncertain application and has not been reproduced.

D.8 This is not to suggest that case law developed in the income tax field will cease to be relevant for corporation tax. Where in substance the same definitional and computational rules still apply both for income tax and corporation tax, for example in taxing foreign dividends under Case V of Schedule D, the case law developed in the income tax field would retain an obvious relevance for corporation tax without the need for some statutory direction to that effect.

D.9 The further issue here concerns the extent to which case law principles derived from the basic, long-standing statutory rules for trading profits will be read across to the operating business source by the courts. Generally, it seems reasonable to suppose that the courts would have regard to case law on the computation of trading and property business profits to help settle computational issues arising in the computation of the new operating business profits. For example, the courts' approach to the determination of the borderline between capital and revenue expenditure developed in the context of trading profits appears equally relevant to the computation of operating business profits. But at a number of points it may be desirable to seek to give statutory expression to principles developed by the courts from the basic Case I rules. Comments on the general approach to the preservation of case law, as well as on the specific instances discussed later on in this commentary, would be welcome.

D.10 The references to employment income in the current section 9 have been removed because it is proposed that for corporation tax, employment income will now be part of the operating business profit

and subject to its general computational rules. The exclusion of the references to the computation of pension and social security income reflects the expectation that a company will in practice not have income of that nature. If exceptionally such income did arise, its treatment would be determined by applying the general rules of Schedule D.

Clause 2

D.11 This clause sets out the new enlarged scope of Case I of Schedule D, to encompass the whole of a company's business. It also makes consequential amendments to the rest of Schedule D (which would become the sole Schedule under which corporation tax on income would be charged). The scope of the new Case I is further defined in section 18A introduced by Clause 3.

D.12 As in the case of the other draft amendments in Annex C, the version of section 18 amended is that after the consequential amendments in the ITTOIA are in place (see paragraph 4 above). For clarity, that version is reproduced as an appendix to this commentary with the further amendments proposed by clause 2 added.

D.13 Clause 2(3) amends the opening provisions setting out the overarching scope of Schedule D so as to make a number of substantive changes. It replaces the references to a trade or profession with words, which correspond to the new Case I (see below). The reference to 'the whole of the business carried on....by a company' carries the inference that a company is never to be viewed as carrying on more than one business at the same time. In addition, the exclusion of employment, pension and social security income from the scope of the Schedule is removed – see paragraph D.10 above.

D.14 Finally, the relationship between Schedule D and its Cases and section 11 ICTA is set out. Clause 2(3)(d) ensures that the charge to corporation tax on companies not resident in the UK as set out in that section is not affected by the general provisions in section 18 and section 18A. At present, section 18 imposes liability to income tax on the income of a non-resident company within its scope, where that income is outside the scope of section 11. But, once the ITTOIA takes effect, such liability will be imposed by that Act and the scope of section 18 confined to corporation tax. So no exceptions are necessary to the proposed rule giving precedence to section 11.

D.15 Clause 2(5) sets out the amendments to the Cases of Schedule D. Paragraph (a) replaces Cases I and II of Schedule D with an enlarged Case I, as set out in section 18A. The amendments to Cases III and V are partly consequential but they also remove (in the new context) what remains of the Crown's historic option to choose whether to tax sums which have the characteristics both of trading receipts and of 'pure income profit' under Case I or, on the other hand, under Case III

or V. The effect of the change of wording is that if a sum can be regarded as a receipt of the operating business it must be so regarded. That is already the position as regards, for example, credits under the loan relationships rules. The relevant parts of paragraph 84 of Schedule 18 to Finance Act 1998 would be repealed as a consequence. But there is no intention to change the effect of the current rules regarding the circumstances in which the payer must deduct income tax from a sum affected by the abolition of the option.

D.16 The residual charging role of Case VI is retained. Profits of a revenue nature from the provision of some service or facility not capable of being brought to account under the other cases of Schedule D would remain within its compass, though as at present such profits seem unlikely to arise very often in practice. Clause 4 contains a power to make regulations to deal with the treatment of the many items brought within Case VI by specific provisions (see paragraphs D.39 to D.41 below).

Clause 3

General

D.17 This clause introduces a new section 18A of ICTA setting out the new Case I of Schedule D.

D.18 The opening words contain the general description of the scope of Case I. Instead of encompassing trading profits only, the new Case I charge to corporation tax is on the profits of the whole of the business (tagged the ‘operating business’), wherever carried on. As noted in paragraph D.13 above, the new section 18(1)(aa) makes it clear that a company will not be regarded as carrying on more than one such ‘business’ at the same time.

D.19 While the scope of such a ‘business’ is subject to a number of detailed rules in section 18A, no general definition of the term itself is attempted. It is of course already a statutory term used in a variety of contexts. In the direct tax field, for example, we have a business for Schedule A purposes and the concept of investment business. Whether a company carries on a business has also been the subject of litigation in connection with small companies’ relief for the purposes of corporation tax.

D20 The term normally takes its meaning from the context but the observations of Lord Diplock in a Privy Counsel tax case decided in 1978 has been referred to in most subsequent cases on the point:

"Business" is a wider concept than "trade" … In the case of a private individual it may well be that the mere receipt of rents from property that he owns raises no presumption that he is carrying on a business. In contrast, in their Lordships’ view, in the case of a company incorporated for the purpose of making profits for its shareholders any

gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business. Where the gainful use to which a company's property is put is letting it out for rent, their Lordships do not find it easy to envisage circumstances that are likely to arise in practice which would displace the prima facie inference that in doing so it was carrying on a business.

The carrying on of "business", no doubt, usually calls for some activity on the part of whoever carries it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between.[1]

D.21 Comments are invited on whether the use of the term 'business' here, qualified as it is by the various detailed rules, is considered satisfactory and, if not, how the term 'business' could be generally defined.

Exclusion of investment activities from operating business profits

D.22 Paragraphs 1 and 2 of new Case I are principally concerned with the exclusion of various amounts from the computation of the profits of the operating business. In terms of current law the effect is to tax as a single source the whole of a company's commercial activities excluding incomings and outgoings relating to investment business (though there will be some circumstances, such as in calculating double taxation relief, where the overall profit from that source will need to be analysed). The exclusions are not so worded as to remove business activities themselves from the ambit of the operating business, only specific amounts. A business of investment for example would still be an operating business even if the cumulative effect of the exclusions in paragraph 2 would be to remove all the receipts and expenses relating to those activities from the operating business profit.

D.23 The fact that the scope of the operating business itself is not cut down by paragraph 2 of the new Case I is a matter of practical relevance in applying other rules which turn on whether expenditure is incurred or assets held for the purposes of the operating business. See for example the proposed computational rule corresponding to section 74(1)(a) ICTA, introduced by paragraph 11 of the draft Schedule.

D.24 Paragraph 2(1)(a) does no more than repeat the effect of section 208 of ICTA, locating it conveniently among the other provisions on the scope of the operating business.

D.25 Paragraph 2(1)(b) excludes foreign dividends, defined in paragraph 2(3), except for dividends, which have the character of trading receipts. Since a trade will no longer be a separate source for

[1]American Leaf Blending Co v Director-General of Inland Revenue (reported [1978] STC 561)

computing the Case I profit the exception works by asking whether, if the company was within the charge to income tax, the dividend would be brought into account in computing its profits from any trade it carries on. This test illustrates how rules and case-law principles concerned with trading profits could continue to be used in various ancillary ways in the operating business computation (see also paragraph D.33 below). By asking how something would be treated if a company was within the charge to income tax for the period in question, the income tax rules and principles to be applied are those for that current period.

D.26 As explained in paragraph D.15, the intention is to abolish the Crown option for corporation tax. The precise wording of the test here rests on the assumption that the proposal to abolish the Crown option for income tax in the ITTOIA (so that dividends with the character of trading receipts must be included in the computation of trading profits) is in fact enacted. See 'Change 1' in the Annex to the Explanatory Notes to the draft ITTOI Bill published earlier this year.

D.27 Paragraphs 2(1)(c) and (d) exclude from the computation of operating business profits 'non-trading' credits and debits arising under the loan relationships and derivative contracts codes. At present credits and debits under these codes which do not qualify to be brought into account in the computation of a company's trading profits are aggregated and accounted for separately. The amendments in paragraph 26 and 35 of the Schedule (see paragraphs D.55 and D.61 below) ensure that, in addition to trading debits and credits under current law, those relating to a company's property letting activities are also brought into the computation of operating business profits, rather than into the separate 'non-trading' computation.

D.28 Similarly, paragraph 2(1)(e) excludes 'non-trading' debits and credits under the rules for intangible fixed assets in Schedule 29 Finance Act 2002. These are currently defined to include not only debits and credits brought into account in computing trading profits but also those brought into account in computing property letting business profits. That definition is therefore used here without amendment though amendments would be needed to other provisions in Schedule 29 on which it depends (see paragraph D.61 below).

D.29 Paragraphs 2(1)(f) and (g) exclude from the computation of operating business profits capital allowances and balancing charges in respect of plant or machinery used for the purpose of the management of a company's investment business.

D.30 Paragraph 2(1)(h) excludes profits or losses arising in respect of the occupation of woodlands subject to an exception for 'short rotation coppice'. The effect is to preserve the current exclusion of woodlands profits and losses from the scope of corporation tax. Profits and losses from the cultivation of short rotation coppice would remain

outside this exclusion and would normally included in operating profits.

D.31 Paragraph 2(1)(i) excludes in essence sums which are currently treated as expenses of management from the computation of operating business profits. To avoid circularity, this is achieved by a double test.

D.32 The first leg is that the expenses in question would have been deductible under section 75 of ICTA (expenses of management). This is on the assumption that they were not deductible in computing operating business profits, reflecting the rule in section 75(2) that expenses otherwise deductible cannot be relieved under the section. This therefore would disallow all expenses which meet the positive conditions in section 75.

D.33 Without a further rule, the expenses passing this test could include items which are otherwise themselves deductible in computing operating business profits, for example expenses concerned with the management of investments which take the form of let property. So the second leg of the double test is that, if the company were within the charge to income tax, the expenses would not be deductible in computing profits of a trade or property business (as it is expected to be defined in the ITTOIA). See paragraph D.25 above for an example of a similar hypothetical test.

Other provisions concerned with the scope of the operating business

D.34 Paragraph 3 of Case I provides that a venture in the nature of a trade is to be regarded as part of its operating business. This rule is based on that in section 832(1) in relation to trades. The wording, removing the archaic elements of the current version, reflects work on rewriting tax law, which has led to the ITTOIA. The rule has been included because a brief ‘venture’ may not exhibit a sufficient degree of continuity and organisation to be viewed as a ‘business’, just as it may not amount to a ‘trade’. The existing case law concerned with the scope of the provision in section 832(1) would be relevant to the construction of the rule in paragraph 3.

D.35 Similarly, paragraph 4 brings individual transactions concerned with the letting or similar exploitation of real property within the ambit of an operating business. This reads across from the current paragraph 1(2) of Schedule A.

D.36 Paragraph 5 ensures that offices and employments are part of a company’s operating business (see paragraph D.10 above).

D.37 Paragraph 6 excludes activities without a view to profit (other than those undertaken in the exercise of statutory functions) from the ambit of an operating business by means of rules broadly similar to those

restricting the set-off of uncommercial losses from a property business (section 392A of ICTA) or trade (section 393A).

D.38 In relation to most activities, paragraph 6 may be seen as reproducing in statutory form the case-law principle that a profit-making intention is generally a necessary condition for the existence of a trade. An exception is farming and market gardening in the UK, which is currently deemed to be a trade (by section 53(1) of ICTA) regardless of the degree of commercial motivation. It is not envisaged that there would be an equivalent to this provision in the new scheme. The effect would be that 'hobby farming' would not amount to all or part of an operating business, whereas at present it does amount to a trade but the set-off of losses from it is subject to restrictions.

Clause 4

D.39 This clause contains the first of two powers to fill out the details of the reforms in Treasury regulations and is concerned with the treatment of items which, generally or in some circumstances, may at present be taxed under Case VI of Schedule D. If the reforms proceed these regulations would be published in draft for comment. The intention would be to include items which currently fall within Case VI in the operating business result where they are linked with activities the profits from which would be taxed under the new Case I.

D.40 A sum may only to be taxed under Case VI as a fallback if there is no trade to which it can be attached, for example under sections 83A(4) (gifts to charity) or 776 (artificial transactions in land). In such a case the regulations would provide that it should be taxed as a receipt of the operating business if such a business was in existence and only otherwise under Case VI. Since an operating business is a wider notion than a trade, the effect would be to reduce the occasions when sums were taxed under Case VI. It would also be possible to go further and provide that where particular sums arose after the operating business to which it relates has ceased, the operating business would be deemed to continue in existence. This would provide a convenient means to enable operating business losses and expenses to be set against post-cessation receipts of all descriptions.

D.41 Case VI would remain the head of charge:

- for sums which exhibit no link with any source of corporate income (for example the charge to counter a tax advantage from certain transactions in securities under section 703(3) ICTA); or

- where the Case VI charge relates to sums which would in any event be excluded from the operating business source by the rules in paragraph 2 of Case I described in paragraph D.22 onwards above (for example the recovery of excess relief for expenses of management under section 75B(7)(b) ICTA).

Clause 6

D.42 This clause contains the other power in the exposure draft to make consequential amendments in regulations. The principal power is to enable current statutory references to a trade or a type of property business to be changed to an ‘operating business’. The change would ensure, for example, that rules giving relief for specific items of expenditure in the computation of the taxable profits from these sources (such as those to be found in section 79 onwards of ICTA) can be made to continue to apply in computing operating business profits. But, as noted in paragraph 2.38, making changes of this nature is not simply a mechanical exercise; there will be references to trades and property business which will continue to work satisfactorily without amendment in the new context.

Schedule – Part 1 – Amendments to ICTA

D.43 A number of provisions are repealed because they are concerned with the scope of the charge for the categories of income which are superseded by the new Case I source.

Paragraph of Schedule	Provision repealed
2	Section 6(4)(b) (definition of ‘trade’ for certain purposes)
4	Schedule A charging provision
5	Section 53 (farming and occupation of land for commercial purposes)
6	Section 55 (mines etc)
8	Section 70A (profits from overseas letting)
16	Section 98 (tied premises)
18	Section 119 (mining rents)
19	Section 120 (wayleave rentals)
22	Section 503 (furnished holiday lettings)

D.44 Paragraph 9 substitutes a revised version of section 72 ICTA which sets out the procedure in calculating the profits of an accounting period, taxable under Schedule D, from those of a period of account which does not coincide. No substantive change in the procedure is involved over the position under current law but the fuller and clearer wording is modelled on the ITTOIA (see for example section 203).

D.45 Paragraphs 10, 11, 14 and 15 set out general rules about deductions in computing the profits of an operating business which correspond to some of the provisions concerned with trading profits in section 74 ICTA at the moment. The wording of these rules is closely modelled on the rewritten ITTOIA versions of these provisions as follows:

Provision	ICTA	ITTOIA	Paragraph In draft Schedule
Purpose of expenditure	s74(1)(a)	s34(1)(a)	11(1)(a)
Unconnected losses	s74(1)(e)	s34(1)(b)	11(1)(b)
replacement of tools	s74(1)(d) (part)	s68	14
capital expenditure	s74(1)(f)	s33	10
insurance recoveries	s74(1)(l)	s106	15

D.46 Apart from section 74(1)(j) (bad debts – see paragraph D.49 below,) there are no provisions corresponding to the other rules in section 74(1) (paragraphs (b), (c), (d - part) (g), (h), (k) and (m) – (p). These provisions are now effectively obsolete and will not be rewritten in the ITTOIA.

D.47 Paragraph 10 also includes explicit provision to exclude capital receipts from the operating business – compare section 96 of the ITTOIA.

D.48 Paragraph 12 has no direct equivalent in the current statute. Instead it reflects the case-law principle that expenditure incurred by a company for purposes concerned with the ownership of the company itself, rather than the company's ownership of its assets etc, is not expenditure incurred for the purposes of its trade. The principle is set out for example in the speeches of the House of Lords in Morgan v Tate and Lyle (1954 – 35 TC 367). It is not clear that, in the absence of express provision, the principle would read across to circumstances where the test concerns the purposes of the wider notion of a business, rather than those of a trade.

D.49 Paragraph 13 amends the proposed new section 88D, also published with the Pre-Budget Report on 2nd December 2004. The new section would replace section 74(1)(j) and a definition to replace that in section 74(2) would be added to section 834(1) ICTA. The document, *International Accounting Standards: Tax Implications* containing the draft section and a technical commentary is to be found under http://newinternet.inrev.gov.uk/menus/consult.htm.

D.50 Paragraph 17 is concerned with the appropriation of stock in trade and seeks to preserve the Inland Revenue's understanding of two points from the case law on the computation of trading profits, both concerned with the construction of the basic charging provisions of Case I. First, there is the treatment of trading stock, which becomes or ceases to be stock in trade without changing owner. The leading case here is Sharkey v Wernher (1955, 36 TC 275). The principle arising from that case, that a trading deduction or receipt arises equal to the market value of the asset in question, lies behind section 161 TCGA. Secondly, there is the line of cases on whether the acquisition

or disposal of trading stock is in the ordinary course of trade and the consequences where that is not the case (see for example Craddock v Zevo Finance – 1946 27 TC 267). The proposition that trading stock given away is not disposed of in the ordinary course of trade lies behind the rule in section 83A ICTA (gifts of trading stock to charity).

D.51 There is no strong reason to suppose that cases concerned with these principles of case-law would be decided differently if the trade in question were part of an operating business source, rather than a taxable source in itself. But the giving of statutory expression to the case-law principle makes the law on this issue more certain and transparent.

D.52 The provisions are modelled on those in the version of the draft ITTOIA published in March. They have subsequently been omitted but the arguments for and against codifying these principles in the context of corporate business are not necessarily on all fours with those in relation to unincorporated traders. For example, trading stock taken by, say, the directors of a family-controlled company for their personal consumption involves a change of ownership and may well be a transaction in the ordinary course of trade if there is adequate consideration.

D.53 The draft provisions do not attempt to set out in statute the circumstances where the acquisition or disposal of trading stock may be regarded as not in the ordinary course of trade. The second line of decided cases would still be relevant to that question.

D.54 Paragraphs 18-23 deal with relatively minor changes.

Schedule – Part 2 – Amendments to loan relationships provisions

D.55 Paragraphs 24 to 30 set out the principal amendments to the provisions governing companies' loan relationships in Finance Act 1996 and ensure that the debits and credits brought to account in computing operating business profits include those linked to a property (letting) business as well as those linked to a trade. The definition of an 'operating business' which would be inserted in section 832 ICTA by paragraph 23 of the Schedule would apply for the purposes of the loan relationships rules (without further express provision). 'Property business' would be defined by a new section 103A Finance Act 1996 introduced by paragraph 23 of the Schedule (see paragraph D.57 below).

D.56 The core amendment is that to section 82 Finance Act 1996 in paragraph 26, identifying the debits and credits to be brought into account in this way. Sums not brought into account in this way ('non-trading' items) would be excluded from the computation of operating business profits by paragraph 2(1)(c) of Case I and be taken into account separately as set out in section 83.

D.57 Paragraph 28(3) amends section 103(2) so that it defines the circumstances in which a company is a party to a creditor relationship for the purpose of the operating business. This is achieved by extending the current 'integral part of the trade' test to a property business. Paragraphs 27 and 30 introduce corresponding amendments – to section 100 (which deals with debts not arising from the lending of money and exchange gains and losses) and to paragraph 4 of Schedule 8 (the definition of non-trading profits against which past deficits on non-trading loan relationship can be set).

D.58 Paragraph 29 introduces a new section 103A into Finance Act 1996 to define 'property business'. This is necessary because it would no longer be possible to do so by reference to Schedule A and section 70A following their repeal. The concept still exists for income tax, however, and the new definition draws on the ITTOIA as follows:

- subsection (1) is based on sections 264 and 265;
- subsections (2) to (5) are based on section 266;
- subsections (6) and (7) are based on section 364;
- subsection (8) is based on section 363.

D.59 Note that it is not necessary to reproduce those detailed rules for which deal with the borderline between property letting or trading since either way the debits and credits would be brought into the computation of operating business profits.

Schedule – Parts 3 to 5

D.60 Paragraph 32 ensures that the principles to be applied in the computation of trading profits set out in section 42 Finance Act 1998 would apply to the computation of operating business profits.

D.61 Paragraph 35 makes amendments to the rules for derivative contracts which are parallel to the amendments to the loan relationship code.

D.62 Paragraphs 37 to 39 make consequential amendments to the rules for intangible fixed assets so that the definition of 'non-trading' deficits and credits in paragraph 34 of Schedule 29, to which paragraph 2(1)(e) of Case I in Clause 3 refers, would continue to work correctly.

Appendix to Annex D: section 18 ICTA including the amendments proposed by paragraph 9 of Schedule 1 to the Income Tax (Trading and Other Income) Bill and the further amendments in Annex C to this Technical Note

(1) The Schedule referred to as Schedule D is as follows:-

SCHEDULE D

Tax under this Schedule shall be charged in respect of-

(aa) the profits of the whole of the business carried on (whether wholly or partly in the United Kingdom or wholly or partly outside the United Kingdom) by a company, whether or not resident in the United Kingdom;

(a) the annual profits arising or accruing-

(i) to any person residing in the United Kingdom from any kind of property whatever situated in the United Kingdom or elsewhere, and

(ii) ....

(iii) to any person, whether Commonwealth citizen or not, although not resident in the United Kingdom from any property whatever in the United Kingdom, and

(b) all interest of money, annuities and other annual profits or gains not specially exempted from tax,

but, in the case of a company which is not resident in the United Kingdom, this Schedule (and the Cases set out in subsection (3) below and section 18A) are subject to section 11.

(2) Tax under Schedule D shall be charged under the Cases set out In subsection (3) below (and section 18A), and subject to and in accordance with the provisions of the Tax Acts applicable to those Cases respectively.

(3) The Cases are-

Case I This Case is set out in section 18A (corporation tax in respect of the profits of the whole of the business carried on (whether wholly or partly in the United Kingdom or wholly or partly outside the United Kingdom) by a company, whether or not resident in the United Kingdom);

Case III: Tax in respect of –

(a) profits and gains which, as profits and gains arising

from loan relationships, are to be treated as chargeable under this Case by virtue of Chapter 2 of Part 4 of the Finance Act 1996;

(b) any annuity or other annual payment which-

(i) is payable (whether inside or outside the United Kingdom and whether annually or at shorter or longer intervals) in respect of anything other than a loan relationship; and

(ii) is not a payment chargeable under Case I;

(c) any discount arising otherwise than in respect of a loan relationship and not being income chargeable under Case I;

Case V: Tax in respect of income arising from possessions out of the United Kingdom not being -

(a) income chargeable under Case I, or
(b) income falling within paragraph (a) of Case III;

Case VI: Tax in respect of any profits not falling under any other Case of Schedule D.

(3A)....................

(3B) The references in Case V to income arising from possessions out of the United Kingdom, shall be taken, in the case of relevant foreign holdings, to include references to the following-

(a) any proceeds of such a sale or other realisation of coupons for foreign dividends as is effected by a bank in the United Kingdom which pays the proceeds over or carries them into an account;

(b) any proceeds of a sale of such coupons to a dealer in coupons in the United Kingdom by a person who is not a bank or another dealer in coupons.

(3C) In this section "relevant foreign holdings" means-

(a) any securities issued by or on behalf of a government or a public or local authority in a country outside the United Kingdom; or

(b) any shares or securities issued by or on behalf of a body of persons not resident in the United Kingdom;

and "securities" here includes loan stock and similar securities.

(3D) In this section "foreign dividends" means-

(a) in relation to relevant foreign holdings falling within subsection (3C)(a) above, interest or annual payments payable out of the revenue of the government or authority in question; and

(b) in relation to relevant foreign holdings falling within subsection (3C)(b) above, any dividends, interest or annual payments payable in respect of the holdings in question.

(3E) In this section-

(a) "bank" has the meaning given by section 840A; and

(b) references to coupons include, in relation to any foreign dividends, warrants for and bills of exchange purporting to be drawn or made in payment of those dividends.

(4) The provisions of Schedule D and of subsection (2) above are without prejudice to any other provision of the Tax Acts directing tax to be charged under Schedule D or under one or other of the Cases set out in subsection (3) above (or section 18A), and tax directed to be so charged shall be charged accordingly.

(4A) Subsections (1) to (4) apply for corporation tax purposes only.

(5) Parts III and IV contain further provisions relating to the charge to tax under Schedule D and under ITTOIA 2005 (see, in particular, the charge under Chapter 2 of Part 2 of that Act (trade profits).

Draft Clause and Schedule

CONTENTS

1 Leases of plant or machinery etc

Schedule 1 — Long funding leases of plant or machinery etc
Part 1 — Capital allowances
Part 2 — Corporation tax
Part 3 — Income tax

1 Leases of plant or machinery etc

Schedule 1 (which makes provision in relation to leases) has effect.

SCHEDULES

SCHEDULE 1

Section 1

LONG FUNDING LEASES OF PLANT OR MACHINERY ETC

PART 1

CAPITAL ALLOWANCES

Introductory

1 CAA 2001 is amended as follows.

Expenditure on plant or machinery for long funding leasing not to be qualifying expenditure

2 After section 34 insert—

"34A Expenditure on plant or machinery for long funding leasing not to be qualifying expenditure

Expenditure is not qualifying expenditure if it is incurred on the provision of plant or machinery for leasing under a long funding lease (see Chapter 6A).".

Commencement of leasing under long funding lease: disposal events and disposal values

3 (1) Section 61 (disposal events and disposal values) is amended as follows.

(2) In subsection (1) (disposal events) after paragraph (e) insert—

"(ee) the plant or machinery begins to be leased under a long funding lease (see Chapter 6A);".

(3) After subsection (1) insert—

"(1A) But a person who is or has been required to bring into account a disposal value in respect of any plant or machinery by virtue of item 5A or 5B in the Table in subsection (2) is not required to bring into account any further disposal value in respect of that plant or machinery.".

(4) In subsection (2) (disposal values) in the Table, after item 5 insert—

"5A.	Commencement of a long funding lease of the plant or machinery where, in accordance with generally accepted accounting practice, the lease falls (or would fall) to be accounted for by the lessor as a finance lease or a loan.	An amount equal to that which, in accordance with generally accepted accounting practice, falls (or would fall) to be shown in the lessor's accounts as his net investment in the lease at its inception.
5B.	Commencement of a long funding lease of the plant or machinery where, in accordance with generally accepted accounting practice, the lease falls (or would fall) to be accounted for by the lessor as an operating lease.	An amount equal to the market value of the plant or machinery at the inception of the lease.".

(5) In item 6 in that Table (which refers to the occurrence of an event within items 1 to 5) for "5" substitute "5B".

Lessee under long funding lease: capital allowances, disposal events and disposal values

4 In Chapter 6 of Part 2 (hire-purchase etc and plant or machinery provided by lessee) after section 70 insert—

"*Lessees under long funding leases*

70A Entitlement to capital allowances

(1) This section applies if a person carrying on a qualifying activity incurs expenditure (whether or not of a capital nature) on the provision of plant or machinery for the purposes of the qualifying activity under a long funding lease.

(2) In the application of this Part in the case of that person, the plant or machinery is to be treated as owned by him at any time when he is the lessee under the long funding lease.

That is so whether or not the lease also falls to be regarded as a long funding lease in the application of this Part in the case of the lessor.

(3) The person is to be treated for the purposes of this Part as having incurred capital expenditure on the provision of the plant or machinery as follows.

(4) The capital expenditure is to be treated as incurred at the inception of the long funding lease.

(5) The amount of the capital expenditure varies, according to whether the long funding lease is or is not a finance lease.

(6) If the long funding lease is a finance lease, the amount of the capital expenditure is the amount that falls (or would fall) to be recognised in the person's accounts in accordance with generally accepted accounting practice as the present value, at the inception of the lease, of the minimum lease payments.

(7) If the long funding lease is not a finance lease, the amount of the capital expenditure is the market value of the plant or machinery at the inception of the lease.

That market value is to be determined on the assumption that the plant or machinery is not encumbered by the lease.

(8) References in this section to a long funding lease being a finance lease are, in the case of any person, references to the lease being one which falls (or would fall) in accordance with generally accepted accounting practice to be accounted for by that person as a finance lease or a loan.

(9) See Chapter 6A for interpretation of this section.

70B Disposal events and disposal values

(1) This section applies where—

(a) a person is treated under section 70A(2) as owning plant or machinery, and

(b) the term of the lease comes to an end.

(2) If, in the case of that person, the lease is not a finance lease—

(a) the coming to an end of the term of the lease is a disposal event,

(b) the person is required to bring into account a disposal value for the chargeable period in which that disposal event occurs, and

(c) the amount of the disposal value is equal to the market value, as estimated by the person at the inception of the lease, of the plant or machinery at the end of the term of the lease.

(3) If—

(a) the plant or machinery is sold by the lessor, and

(b) some or all of the proceeds of sale are paid to the person,

subsection (4) applies.

(4) In any such case—

(a) there is a disposal event when the payment becomes receivable,

(b) the person is required to bring into account a disposal value for the chargeable period in which that disposal event occurs, and

(c) the amount of the disposal value is the amount of the payment.

Any disposal value required to be brought into account under this subsection by a person is in addition to any other disposal value required to be brought into account by him in respect of the plant or machinery.

(5) This section is to be construed as one with section 70A.

Interpretation of provisions relating to long funding leases

5 In Part 2, after Chapter 6 insert—

"**CHAPTER 6A**

INTERPRETATION OF PROVISIONS ABOUT LONG FUNDING LEASES

70C Introductory

This Chapter makes provision for the interpretation of this Part so far as relating to long funding leases.

70D "Long funding lease"

A "long funding lease" is a funding lease the term of which is longer than 4 years.

70E "Funding lease"

(1) A "funding lease" is a plant or machinery lease which at its inception meets one or more of the following tests—
 (a) the finance lease test (see section 70F),
 (b) the lease payments test (see section 70G),
 (c) the useful economic life test (see section 70H),
 (d) the specialised asset test (see section 70I).
That is subject to the following provisions of this section.

(2) A plant or machinery lease is not a funding lease if—
 (a) section 67 applies (plant or machinery treated as owned by person entitled to benefit of contract, etc), and
 (b) the lease is the contract mentioned in that section.

(3) A plant or machinery lease is not a funding lease if—
 (a) before the inception of the lease, the plant or machinery has been leased under one or more other plant or machinery leases,
 (b) in the aggregate, the terms of those other leases exceed 75% of the remaining useful economic life of the plant or machinery at the inception of the earliest of them, and
 (c) none of those earlier leases was a funding lease or would have been a funding lease if it had been entered into after the coming into force of section 70A.

70F The finance lease test

(1) A lease meets the finance lease test in the case of any person if 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 accounts—
 (a) of that person, or
 (b) of any person connected with that person.

(2) In this section "accounts", in relation to a company, includes any accounts which—
 (a) relate to two or more companies of which that company is one, and

(b) are drawn up in accordance with either of the following provisions (which relate to group accounts)—
  (i) section 227 of the Companies Act 1985,
  (ii) Article 235 of the Companies (Northern Ireland) Order 1986.

70G The lease payments test

(1) A lease meets the lease payments test if the present value of the minimum lease payments, including any initial payment, is equal to 75% or more of the fair value of the leased plant or machinery.

(2) The present value of those payments is to be calculated by using the interest rate implicit in the lease.

(3) Here "fair value" means—
  (a) the market value of the leased plant or machinery,
    less
  (b) any grants receivable towards the purchase or use of that plant or machinery.

70H The useful economic life test

A lease meets the useful economic life test if the term of the lease is more than 50% of the remaining useful economic life of the leased plant or machinery.

70I The specialised asset test

A lease meets the specialised asset test if use of the asset after the end of the term of the lease by a person other than the lessee cannot reasonably be expected to be commercially practicable.

70J "Minimum lease payments"

(1) In the case of any lease, the minimum lease payments are the minimum payments under the lease over the term of the lease (including any initial payment) together with—
  (a) in the case of the lessee, so much of any residual amount as is guaranteed by him or a person connected with him, or
  (b) in the case of the lessor, so much of any residual amount as is guaranteed by the lessee or by an independent third party.

(2) In determining the minimum payments, exclude so much of any payment as represents—
  (a) charges for services, or
  (b) qualifying UK or foreign tax to be paid by the lessor.

(3) In this section—
  "independent third party" means a person who is not connected with the lessor or the lessee;
  "qualifying UK or foreign tax" means any tax or duty chargeable under the law of any part of the United Kingdom, or under the law of any foreign country, other than—
    (a) income tax,
    (b) corporation tax,

(c) any tax chargeable under the law of a foreign country which is similar to income tax or corporation tax,

and here "foreign country" means any territory outside the United Kingdom;

"residual amount" means so much of the fair value of the plant or machinery subject to the lease as cannot reasonably be expected to be recovered by the lessor from the payments under the lease.

(4) Here "fair value" means—

(a) the market value of the leased plant or machinery,

less

(b) any grants receivable towards the purchase or use of that plant or machinery.

70K The "term" of a lease

The term of a lease is the period comprising—

(a) the period for which the lessee has contracted to lease the asset, and

(b) any further periods for which—

(i) the lessee has an option to continue to lease the asset (whether with or without further payment), and

(ii) it is reasonably certain, at the inception of the lease, that the lessee will exercise that option.

70L General definitions

(1) Construe these expressions as follows—

"the finance lease test" means the finance lease test in section 70F;

"fixture"—

(a) means any plant or machinery that is so installed or otherwise fixed in or to a building or other description of land as to become, in law, part of that building or other land, and

(b) includes any boiler or water-filled radiator installed in a building as part of a space or water heating system;

"funding lease" has the meaning given by section 70E;

"inception", in relation to a plant or machinery lease, means the earlier of—

(a) the time when the leased plant or machinery is brought into use;

(b) the date from which payments under the lease first accrue;

"initial payment", in the case of a plant or machinery lease, means a payment by the lessee—

(a) at or before the time when the lease is entered into, and

(b) in respect of the plant or machinery which is the subject of the lease;

"land lease" means any lease of land, and for this purpose "lease" includes each of the following—

(a) an underlease, sublease or any tenancy or licence,

(b) in England and Wales or Northern Ireland, an agreement for a lease, underlease, sublease, tenancy or licence,

(c) in Scotland, an agreement (including missives of let not constituting a lease) under which a lease, sublease, tenancy or licence is to be executed,

(d) in the case of land situated outside the United Kingdom, any interest corresponding to a lease as so defined;

"lessee", in relation to a lease, includes any person entitled to the lessee's interest under the lease;

"lessor", in relation to a lease, includes any person entitled to the lessor's interest under the lease;

"long funding lease" has the meaning given by section 70D;

"plant or machinery lease" means any kind of agreement or arrangement under which a person (the lessor) grants to another person (the lessee) the right to use plant or machinery for a period;

"remaining useful economic life", in the case of any leased plant or machinery, is the period—

(a) beginning with the inception of the lease, and

(b) ending when the asset is no longer used or likely to be used by any person for any purpose as a fixed asset of a business;

"residual value", in relation to any leased plant or machinery, means—

(a) the estimated market value of the leased asset on a disposal at the end of the lease,
less

(b) the estimated costs of that disposal;

"the term", in relation to a lease, is to be construed in accordance with section 70K.

(2) In relation to a lease, any reference to plant or machinery includes a reference to fixtures.

(3) Section 839 of ICTA (connected persons) applies.

(4) Any necessary apportionments under or by virtue of this Chapter are to be made on a just and reasonable basis.".

PART 2

CORPORATION TAX

Introductory

6 ICTA is amended as follows.

Lessors under long funding leases

7 After section 785A insert—

"785B Long funding leases of plant or machinery: lessors under finance leases

(1) This section applies for determining for the purposes of corporation tax the profits of a company for any period of account in which it is the lessor of any plant or machinery under a long funding lease which meets the finance lease test in section 70F of the Capital Allowances Act.

(2) The amount to be brought into account as the lessor's taxable income from the lease for the period of account is the amount stated in subsection (3) or (4) below, as the case may be.

(3) If the lease meets the finance lease test—

(a) by virtue of subsection (1)(a) of section 70F of that Act (lessor's accounts), but

(b) without recourse to subsection (2) of it (group accounts),

the amount is the rental earnings in respect of the lease for the period of account.

(4) Where subsection (3) above does not apply, the amount is so much of the rental earnings in respect of the lease for the purposes of the relevant accounts for any period or periods as is attributable to the period that is the lessor's period of account.

For this purpose, "the relevant accounts" are the accounts by reference to which the lease meets the finance lease test.

(5) The "rental earnings" for any period is the amount which, in accordance with generally accepted accounting practice, falls (or would fall) to be treated as the gross return on investment for that period in respect of the long funding lease where it meets the finance lease test.

785C Long funding leases that are finance leases: sale of asset

(1) This section applies for determining the liability to corporation tax of a company which is or has been the lessor of any plant or machinery under a long funding lease which meets the finance lease test in section 70F of the Capital Allowances Act.

(2) Where—

(a) the term of the lease comes to an end,

(b) the plant or machinery is sold by the company, and

(c) some or all of the proceeds of sale are paid to the lessee,

no deduction in respect of the sum paid to the lessee is allowed in computing the profits of the company.

785D Long funding leases of plant or machinery: lessors under operating leases

(1) This section applies for determining for the purposes of corporation tax the profits of a company for any period of account in which it is the lessor of any plant or machinery under a long funding lease

which does not meet the finance lease test in section 70F of the Capital Allowances Act.

(2) A deduction is allowed in computing the profits of the company for the period of account.

(3) The amount of the deduction for any period of account is to be determined as follows.

(4) From—

(a) the market value of the plant or machinery at the inception of the lease,

subtract

(b) the amount which, at the inception of the lease, is expected to be the market value of the plant or machinery at the end of the term of the lease,

to find the expected gross reduction in value over the term of the lease.

(5) For that purpose the market value of the plant or machinery at the inception of the lease is to be determined on the assumption that the plant or machinery is not encumbered by the lease.

(6) Apportion the amount of that expected gross reduction in value to each period of account in which any part of the term of the lease falls.

(7) The apportionment must be in accordance with section 834(4) (time basis).

(8) The amount of the deduction for any period of account is the amount so apportioned to that period.

785E Long funding leases that are operating leases: sale of asset

(1) This section applies for determining the liability to corporation tax of a company which is or has been the lessor of any plant or machinery under a long funding lease which does not meet the finance lease test in section 70F of the Capital Allowances Act.

(2) If the company sells the plant or machinery at or after the end of the term of the lease, find the following amounts—

(a) the net proceeds of the sale (P),

(b) any sums paid to the lessee out of those net proceeds (L),

(c) the residual value of the plant or machinery, as estimated at the inception of the lease (R).

(3) If (P - L) exceeds R, an amount equal to the excess is to be brought into account as profits of the company in the period of account in which the plant or machinery is sold.

(4) If R exceeds (P - L), a deduction of an amount equal to the excess is allowed against the profits of the company in that period of account.

(5) In computing the profits of the company, no deduction is allowed in respect of any sums paid to the lessee out of the net proceeds of the sale.

785F Long funding leases of plant or machinery: lessees under finance leases

(1) This section applies for determining for the purposes of corporation tax the profits of a company for any period of account in which it is the lessee of any plant or machinery under a long funding lease which meets the finance lease test in section 70F of the Capital Allowances Act.

(2) In calculating the company's profits for the period of account, the amount deducted in respect of amounts payable under the lease must not exceed the amounts which, in accordance with generally accepted accounting practice, fall (or would fall) to be shown in the company's accounts as finance charges in respect of the lease.

785G Long funding leases of plant or machinery: lessees under operating leases

(1) This section applies for determining for the purposes of corporation tax the profits of a company for any period of account in which it is the lessee of any plant or machinery under a long funding lease which does not meet the finance lease test in section 70F of the Capital Allowances Act.

(2) The deductions that may be allowed in computing the profits of the company for the period of account are to be reduced in accordance with the following provisions of this section.

(3) The amount of the reduction for any period of account is to be determined as follows.

(4) From—

(a) the market value of the plant or machinery at the inception of the lease,

subtract

(b) the amount which, at the inception of the lease, is expected to be the market value of the plant or machinery at the end of the term of the lease,

to find the expected gross reduction over the term of the lease.

(5) For that purpose the market value of the plant or machinery at the inception of the lease is to be determined on the assumption that the plant or machinery is not encumbered by the lease.

(6) Apportion the amount of that expected gross reduction to each period of account in which any part of the term of the lease falls.

(7) The apportionment must be in accordance with section 834(4) (time basis).

(8) The amount of the reduction for any period of account is the amount so apportioned to that period.

785H Interpretation of sections 785B to 785G

Chapter 6A of Part 2 of the Capital Allowances Act (interpretation of provisions about long funding leases) applies in relation to sections 785B to 785G as it applies in relation to that Part.".

PART 3

INCOME TAX

Introductory

8 ITTOIA 2005 is amended as follows.

Special rules for long funding leases

9 After Part 7 insert the following Part—

"**PART 7A**

LEASES OF PLANT OR MACHINERY: SPECIAL RULES FOR LONG FUNDING LEASES

828A Overview of Part 7A

This Part is concerned with leases of plant or machinery which are long funding leases, and provides for—

(a) the amount which is to be brought into account as the lessor's taxable income from a long funding lease which is a finance lease,

(b) no deduction to be allowed to the lessor, in the case of such a lease, in respect of so much of the proceeds of a sale of the plant or machinery as is paid to the lessee;

(c) a deduction in calculating for any period of account the profits of the lessor under a long funding lease which is not a finance lease,

(d) increasing the amount of profits chargeable to income tax, or authorising deductions from profits chargeable to income tax, in the case of such a lease, where there is a sale of the plant or machinery and some or all of the proceeds are paid to the lessee,

(e) limiting the amount that may be deducted by the lessee under a long funding lease which is a finance lease in respect of payments under the lease,

(f) reducing the deductions that may be allowed in calculating profits in the case of a lessee under a long funding lease which is not a finance lease.

828B Lessors under finance leases

(1) This section applies for determining for the purposes of income tax the amount of profits of a person for any period of account in which the person is the lessor of any plant or machinery under a long funding lease which meets the finance lease test in section 70F of CAA 2001.

(2) The amount to be brought into account as the lessor's taxable income from the lease for the period of account is the amount stated in subsection (3) or (4) as the case may be.

(3) If the lease meets the finance lease test by virtue of subsection (1)(a) of section 70F of that Act (lessor's accounts), the amount is the rental earnings in respect of the lease for the period of account.

(4) If the lease meets the finance lease test by virtue only of subsection (1)(b) of that section (accounts of connected person), the amount is so much of the rental earnings in respect of the lease for the purposes of the relevant accounts for any period or periods as is attributable to the period that is the lessor's period of account.

For this purpose, "the relevant accounts" are the accounts by reference to which the lease meets the finance lease test.

(5) The "rental earnings" for any period is the amount which, in accordance with generally accepted accounting practice, falls (or would fall) to be treated as the gross return on investment for that period in respect of the long funding lease where it meets the finance lease test.

828C Finance leases: sale of asset

(1) This section applies for determining the liability to income tax of a person who is or has been the lessor of any plant or machinery under a long funding lease which meets the finance lease test in section 70F of CAA 2001.

(2) Where—

(a) the term of the lease comes to an end,

(b) the plant or machinery is sold by the person, and

(c) some or all of the proceeds of sale are paid to the lessee,

no deduction in respect of the sum paid to the lessee is allowed in calculating the profits of the person.

828D Lessors under operating leases

(1) This section applies for determining for the purposes of income tax the profits of a person for any period of account in which the person is the lessor of any plant or machinery under a long funding lease which does not meet the finance lease test in section 70F of CAA 2001.

(2) A deduction is allowed in calculating the profits of the person for the period of account.

(3) The amount of the deduction for any period of account is determined as follows.

(4) From—

(a) the market value of the plant or machinery at the inception of the lease,

subtract

(b) the amount which, at the inception of the lease, is expected to be the market value of the plant or machinery at the end of the term of the lease,

to find the expected gross reduction in value over the term of the lease.

(5) For that purpose the market value of the plant or machinery at the inception of the lease is to be determined on the assumption that the plant or machinery is not encumbered by the lease.

(6) Apportion the amount of that expected gross reduction in value to each period of account in which any part of the term of the lease falls.

(7) The apportionment must be in accordance with section 834(4) of ICTA (time basis).

(8) The amount of the deduction for any period of account is the amount so apportioned to that period.

828E Operating leases: sale of asset

(1) This section applies for determining the liability to income tax of a person who is or has been the lessor of any plant or machinery under a long funding lease which does not meet the finance lease test in section 70F of CAA 2001.

(2) If the person sells the plant or machinery at or after the end of the term of the lease, find the following amounts—

(a) the net proceeds of the sale (P),

(b) any sums paid to the lessee out of those net proceeds (L),

(c) the residual value of the plant or machinery, as estimated at the inception of the lease (R).

(3) If (P - L) exceeds R, an amount equal to the excess is to be brought into account as profits of the person in the period of account in which the plant or machinery is sold.

(4) If R exceeds (P - L), a deduction of an amount equal to the excess is allowed against profits of the person in that period of account.

(5) In calculating the profits of the person, no deduction is allowed in respect of any sums paid to the lessee out of the net proceeds of the sale.

828F Lessees under finance leases

(1) This section applies for determining for the purposes of income tax the profits of a person for any period of account in which he is the lessee of any plant or machinery under a long funding lease which meets the finance lease test in section 70F of CAA 2001.

(2) In calculating the person’s profits for the period of account, the amount deducted in respect of amounts payable under the lease must not exceed the amounts which, in accordance with generally accepted accounting practice, fall (or would fall) to be shown in the person’s accounts as finance charges in respect of the lease.

828G Lessees under operating leases

(1) This section applies for determining for the purposes of income tax the profits of a person for any period of account in which he is the lessee of any plant or machinery under a long funding lease which does not meet the finance lease test in section 70F of CAA 2001.

(2) The deductions that may be allowed in calculating the profits of the person for the period of account are to be reduced in accordance with the following provisions of this section.

(3) The amount of the reduction for any period of account is to be determined as follows.

(4) From—

(a) the market value of the plant or machinery at the inception of the lease,

subtract

(b) the amount which, at the inception of the lease, is expected to be the market value of the plant or machinery at the end of the term of the lease,

to find the expected gross reduction over the term of the lease.

(5) For that purpose the market value of the plant or machinery at the inception of the lease is to be determined on the assumption that the plant or machinery is not encumbered by the lease.

(6) Apportion the amount of that expected gross reduction to each period of account in which any part of the term of the lease falls.

(7) The apportionment must be in accordance with section 834(4) of ICTA (time basis).

(8) The amount of the reduction for any period of account is the amount so apportioned to that period.

828H Interpretation of Part 7A

Chapter 6A of Part 2 of CAA 2001 (interpretation of provisions about long funding leases) applies in relation to this Part as it applies in relation to that Part.”.

Annex F: Leasing Reform - Technical Commentary on the Draft Legislation

Introduction

F.1 The draft legislation in Annex E gives an indication of how the core statutory provisions of the new regime will look. The provisions cover the definition of a long funding lease and the basic computational rules for the new regime.

F.2 This commentary links the draft legislation to the text in chapter 4 and Annex A. The Government would welcome comments on whether the draft achieves the aims set out in the text. Some specific drafting issues are discussed below but comments on any other issues will be very welcome.

F.3 With some minor exceptions the draft deals only with the basic concepts needed for the new regime. It does not, for example, cover situations where there are chains of leases (leases and sub-leases etc), fixtures and transitional issues (paragraphs 4.40 to 4.48), nor does it cover assignments, terminations and successions etc. or more complex option arrangements.

F.4 Furthermore the draft does not deal with rules for specific trades (paragraphs 4.38 and 4.39) or consequential changes such as the removal of the overseas leasing rules and changes to section 220 Capital Allowances Act 2001 ("CAA").

F.5 The draft legislation is presented in the form in which it might appear when enacted. However this commentary first deals with the definition of a long funding lease before turning to the new computational rules.

F.6 The draft legislation is based on the proposed Income Tax (Trading and Other Income) Act ("ITTOIA") having taken effect before leasing reform is enacted.

Definition of a long funding lease

F.7 The definition of a long funding lease is contained in new sections 70D to 70L of CAA, introduced by paragraph 4 of the schedule. The definition is based on four tests, which are themselves based on criteria similar to those used in the accounting standards relevant to leasing as described in paragraphs 4.11 to 4.15.

F.8 Comments on the tests themselves are sought (paragraph 4.16) but the Government would also welcome comments on any issues arising

out of the drafting. Some matters of detail are raised below, but comments on any aspect are welcome.

Section 70D “Long funding lease”

F.9 The definition of a long funding lease is contained in new section 70D. The draft only refers to leases with a term of more than 4 years but, as noted at paragraphs 4.20 and 4.21, the Government proposes that this definition might be extended to exclude more leases. Comments on this exclusion, including the issue discussed at paragraphs A2 to A6 of Annex A, have been invited.

Section 70E “Funding lease”

F.10 Section 70E(1) introduces the four tests for defining a funding lease and provides for the tests to be carried out at inception.

F.11 Section 67 CAA applies, among other things, to leases where the lessee shall or may become the owner of the asset (hire purchase contracts). Its effect is, of course, to give capital allowances to the lessee. Therefore, without specific provision, there would be uncertainty about which set of rules should apply. Section 70E(2) provides that section 67 CAA takes priority over the rules for funding leases.

F.12 The provisions at section 70E(3) address the issue explained in paragraph 4.23 and reflect the suggested solution set out in paragraph 4.24. The Government would welcome comments on whether the policy aim is achieved.

Section 70F The finance lease test

F.13 This test provides that a lease is a funding lease where it is properly accounted for as a finance lease under generally accepted accounting principles. It applies where the lease is accounted for as a finance lease in the accounts of a connected person, including in consolidated accounts.

F.14 Section 70F(1) refers to a lease treated as “a finance lease or a loan”, picking up on the concept used in Schedule 12, FA 1997. Does the reference to “loan” here cause difficulties?

Section 70G The lease payments test

F.15 This test is based on the 90% “presumption” in SSAP 21, but uses a figure of 75% rather than 90%. “Minimum lease payments” and the “term” of a lease are defined at sections 70J and 70K respectively.

F.16 The concepts of “present value” and “interest rate implicit in the lease” are undefined and intended to take their normal commercial meaning. Views on whether this will cause any uncertainty would be welcome, particularly in relation to “interest rate implicit in the lease” in the context of leases classified as operating leases under generally accepted accounting principles. If there is uncertainty, would it help if there were a fuller definition of “interest rate implicit in the lease”, along the lines of the definitions in SSAP21 or IAS 17?

F.17 Will the interest rate implicit in the lease always be determinable, or should the legislation cater for when it is not determinable?

Section 70H The useful economic life test

F.18 The useful economic life test would result in a lease being a funding lease if its term were more than 50% of the remaining useful economic life of the leased asset. The definition of “remaining useful economic life” is in section 70L and follows the definition of long life assets in section 91, CAA. It is similar to one of the IAS 17 definitions of “economic life” (i.e. “the period over which an asset is expected to be economically usable by one or more users”) and would typically be expected to give the same result.

F.19 Comments on the test itself have been invited. Does the drafting give rise to any uncertainties in its application? If so, how might these uncertainties be removed?

Section 70I The specialised asset test

F.20 This test is based on a test in IAS 17 and, as with the other tests, comments have been invited. One of the crucial concepts and words in this test here is “practicable”. The words “viable” and “feasible” were also considered, and both can have similar meanings to “practicable”. Does the drafting give rise to any uncertainties in its application? If so, how might these uncertainties be removed?

Section 70J “Minimum lease payments”

F.21 The definition of minimum lease payments is more detailed than found in the accounting standards in order to reduce uncertainty. Nevertheless, the Government’s aim is to achieve a result that would be recognised as based on typical accounting practice but without relying on the accounting definition itself. The Government would welcome comments on whether that aim has been achieved and, if not, on how the draft legislation could be improved.

Section 70K The "term" of a lease

F.22 As with the definition of "minimum lease payments", the definition of the "term" of a lease is based on accounting practice. As a consequence it incorporates the phrase "reasonably certain", as used in both SSAP 21 and IAS 17. The Government would welcome comments if it is thought this definition might cause uncertainty.

Section 70L General definitions

F.23 Not all the definitions here are needed in defining a long funding lease, but Chapter 6A is applied to the computational provisions found in paragraphs 4, 7 and 9 of the schedule (see new sections 70A CAA, 785H ICTA and 828H ITTOIA).

F.24 The definition of "fixture" is taken from section 173 CAA.

F.25 The definition of "inception" is intended to mirror accounting practice.

F.26 The term "initial payment" is used in the definition of minimum lease payments. It is not defined in SSAP21 and is not used in IAS 17 but the Government believes the concept reduces uncertainty. Comments on whether it achieves this aim and whether the definition reflects generally accepted accounting practice would be welcome.

F.27 The definition of "plant or machinery lease" is obviously key to the new regime because the definition of a funding lease depends upon it (section 70E(1)). Detailed comments are invited on the definition given here, particularly if it might give rise to difficulties or uncertainties in certain situations.

F.28 Subsection 70L(4) is required so that, for example, lease rentals may be apportioned to exclude charges for services and taxes where there is no specific allocation in the lease contract.

Independent determination

F.29 For the purpose of preparing this draft legislation it has been assumed that lessor and lessee take an independent view on whether a lease is a long funding lease. However, paragraph 4.16 invites comment on whether that approach is appropriate. In considering that question it may be helpful to consider these rules and whether they could be successfully applied by the lessor and lessee independently. An obvious alternative would be for the lessor to determine whether a lease is a funding lease or not and inform the lessee accordingly.

Capital allowances

Lessor losing capital allowances

F.30 Paragraph 2 of the schedule inserts new section 34A into CAA. This new section treats expenditure on the provision of plant or machinery to be used for long funding leasing as not qualifying expenditure. Capital allowances are only due on qualifying expenditure (section 11 CAA) and so this section prevents capital allowances being due on the capital expenditure incurred by the lessor.

F.31 Some assets may be used for another purpose before being used for long funding leasing (see paragraph 4.34 and paragraphs A22 and A23 in Annex A). Where this is the case it is suggested that it is appropriate to deem a disposal (schedule, paragraph 3(2)) and that the disposal values should be the net investment in the lease for finance leases or the market value for operating leases. These disposal values are set out in the two new additions to the disposal value table in section 61 CAA (schedule, paragraph 3(4)).

F.32 Because no capital allowances are available to a lessor under a long funding lease there is no need to bring in a disposal value when the asset is sold. Paragraph 3(3) of the schedule caters for this.

Lessee gaining capital allowances

F.33 Paragraph 4 of the schedule introduces new section 70A. This section treats a long funding lessee as incurring, at inception, capital expenditure that qualifies for capital allowances. The amount of that expenditure varies according to lease type –

- if the lease is a finance lease the amount on which capital allowances are due is the present value of the minimum lease payments at inception;
- if the lease is an operating lease the amount on which capital allowances are due is the market value of the plant and machinery at inception.

F.34 New section 70B deals with the need to bring in a disposal value when a long funding lease comes to an end. Subsection (2) provides that where the lease is an operating lease the disposal value is the amount that was estimated at inception to be the market value at the end of the lease. Subsections 70B(3) and (4) deal with the situation where a lessor sells the asset and pays all or part of the proceeds to the lessee.

Corporation tax

F.35 Paragraph 7 of the schedule introduces new sections 785B to 785G ICTA. These sections are, of course, all concerned with corporation tax. Sections 785B to 785E deal with the taxation of lessors and sections 785F and 785G deal with the lessees' lease rental restrictions.

Taxation of rentals - Finance leases

F.36 Where a lease is accounted for as a finance lease, new section 785B limits the taxable income to the rental earnings shown in the accounts.

F.37 Where the lease is not classified as a finance lease by the lessor, but is classified as a finance lease by a connected party (whether in consolidated accounts or not), the lessor's taxable income is based on the rental earnings in the accounts of the connected party, or consolidated accounts, as appropriate. The section also caters for the possibility that the accounting period of the lessor is not that same as that of the connected person by providing that suitable apportionments are made.

F.38 There is, for the moment, an underlying assumption in section 785B that where the taxation is based on the figures in the accounts of a connected person (whether in consolidated accounts or not) then all such accounts will use the same figures. This may not always be the case, for example if accounts are consolidated under IAS 17 but some individual companies use SSAP21, and the final legislation may need to provide for which connected party accounts are followed. Are there other circumstances in which different figures might arise in respect of the same lease?

F.39 New section 785C ensures that where a lessor sells the asset and pays part of the proceeds to the lessee there is no deduction. This is necessary because the sale proceeds themselves will not be brought into account (schedule, paragraph 3(3)).

Taxation of rentals - Operating leases

F.40 New section 785D puts into effect the proposal set out in paragraphs A.12 to A.15 of Annex A. Comments have been invited on the aim of the concept. Further comments are invited on whether the draft legislation achieves its aim.

F.41 As noted at paragraph A.16, this basic rule may need amending to take account of back-loaded leases.

F.42 New section 785E deals with the disposal of assets and provides that any excess over the estimated market value at the end of the lease is treated as income, and any deficit is allowed as a deduction.

Lease rental restrictions – Finance leases

F.43 Where a lease is accounted for as a finance lease, new section 785F restricts the allowable deduction for lease rentals to the finance charges shown in the accounts.

Lease rental restrictions – Operating leases

F.44 Where a lease is accounted for as an operating lease, new section 785G puts into effect the proposal set out in paragraphs A.19 to A.21 of Annex A.

Income tax

F.45 Paragraph 9 of the schedule introduces new sections 828A to 828G ITTOIA. These sections essentially replicate the effect of new sections 785A to 785E ICTA, but for the purposes of income tax. Sections 828A to 828E deal with the taxation of lessors and sections 828F and 828G deal with the lessees' lease rental restrictions.

ABOUT THE CONSULTATION PROCESS – CODE OF PRACTICE ON WRITTEN CONSULTATION

Consultation Criteria

i) Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.

ii) Be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses.

iii) Ensure that your consultation is clear, concise and widely accessible.

iv) Give feedback regarding the responses received and how the consultation process influenced the policy.

v) Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.

vi) Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

The Inland Revenue confirms that, where possible, these consultation criteria have and will continue to be followed. The main questions are summarised at the end of each chapter.

If you have any complaints about any element of the consultation process leading from the issue of this document, please contact:

Steve Webster
Inland Revenue
New Wing
Somerset House
Strand
London
WC2R 1LB

Tel: 020 7438 6535

E-mail: steve.webster@ir.gsi.gov.uk