# Clause 13 and Schedule 8: Leases

## Summary

1. This clause and Schedule implement a package of proposals for income tax and corporation tax rules as a result of the adoption of International Financial Reporting Standard 16 (IFRS 16) for all entities which apply International Financial Reporting Standards or Financial Reporting Standard 101 Reduced Disclosure Framework (FRS 101). The legislation takes effect for periods of account commencing on or after 1 January 2019.

2. The main areas of change are:

   - Amending current legislation that relies on lease accounting definitions
   - Minor amendments to the rules for Long Funding Leases
   - Repealing legislation that stopped entities giving effect to IFRS 16 and introducing rules for the spreading of any transitional adjustment recognised upon adoption of IFRS 16

## Details of the clause and Schedule

3. Clause 13 introduces Schedule 8.

## Schedule 8

## Part 1: Finance leases: Amendments as a result of changes to accounting standards

4. Part 1 of the Schedule makes changes ensuring that the relevant legislation will apply to an IFRS 16 lessee as intended.

5. Paragraph 1 makes the required changes to Part 2 of Capital Allowances Act (CAA) 2001, the most significant of which are explained below.

6. Paragraph 1(2) amends section 67 which sets out the circumstances in which a person is entitled to capital allowance even though they do not own the plant or machinery in question. Currently section 67 applies to hire purchase contracts and leases that are treated as finance leases for accounting purposes. Going forwards, if the lessee uses IFRS 16 they must determine whether they would have accounted for the lease as a finance lease were they required under generally accepted accounting practice to determine whether the lease was a finance lease or not.

7. Paragraph 1(3) inserts the new terminology of 'interest expenses' into section 70E of CAA 2001 to reflect the terminology used in IFRS 16.

8. Paragraph 1(4) amends section 70YA. The amendments have the effect of not requiring a deemed disposal and reacquisition where a long funding lease is reclassified upon the mandatory adoption of a new accounting standard.

9. The following example illustrates how the changes to section 70YA will apply:

   - A lessee uses IFRS or FRS 101 and has a long funding operating lease which has three years left to run as at the 31 December 2019. In its accounts for the year to 31 December 2019 it is required to adopt IFRS 16 and moves from accounting for the long funding operating lease as an operating lease to accounting for the lease under IFRS 16, recognising a right-of-use asset and a lease liability. Section 70YA does not apply and the lease will continue to be taxed using the rules for a long funding operating lease without any deemed disposal or reacquisition.

10. Paragraph 1(5) amends the definition of a "long funding finance lease" in section 70YI so that all lessees using IFRS 16 and who have a long funding lease in respect of a right-of-use asset will be defined as having a long funding finance lease. It inserts a new definition into subsection 70YI(1) that defines a "right-of-use lease" to identify those lessees using IFRS 16.

11. Paragraph 1(6) amends section 228J which provides for plant or machinery leases that are subject to further operating leases. If the lessee uses IFRS 16 they must determine, for any lease in respect of a right-of-use asset, whether they would have accounted for the lease as a finance lease were they required under generally accepted accounting practice to determine whether the lease was a finance lease or not.

12. Paragraph 2 amends the income tax rules for computing the deduction claimed by a lessee with a long funding finance lease. The substantial changes are explained below.

13. Paragraph 2(3) introduces new section 148GA of ITTOIA 2005. The new section applies in certain circumstances and will either increase or decrease the deduction claimed for income tax purposes for a lessee using IFRS 16 with a long funding finance lease. The new section identifies two circumstances where a lessee using IFRS 16 with a long funding finance lease will have a change in their rental payments and allows an increased deduction based upon how any rental increase is reflected in its accounts or imposes a restriction of its deduction if the rental payments decrease.

14. New sections 148GA(1)(a) and (b) apply where the lessee uses IFRS 16, has a long funding finance lease and where there is a change in the rental payments in any period of account.

15. New sections 148GA(1)(c)(i) and (ii) provide that the section only applies where the change in rental payments:

- Results in a remeasurement of the lease liability in the lessee's accounts, or
- Is recognised in the accounts as an amount paid under the lease but not as an amount accounted for as an interest expense that relates to a right-of-use lease nor as depreciation, or an impairment, of that right-of-use asset.

16. New section 148GA(2) provides that where the section applies the lessee will adjust the deduction limitation under section 148G of ITTOIA 2005 by the amount its accounting deduction in its profit and loss account is adjusted by as a result of the change in rentals which meets the tests in new sections 148GA(1)(c)(i) and (ii).
17. New section 148GA(3) provides that there is no adjustment to the limitation under section 148G of ITTOIA 2005 if the remeasurement or deduction results in enhanced capital expenditure provided for under section 70D of CAA 2001.
18. Illustrating how this applies are the following two examples.

    - A lessee has adopted IFRS 16 and has a long funding finance lease. At the end of year 5 the lease terms require the lessee to pay a one off rental based upon the number of widgets produced by the leased plant and machinery giving rise to a rental payment of £100,000. The lessee accounts for the payment as a debit in the profit or loss, but not as an interest expense, in year 5. New section 148GA provides that the deduction claimed by the lessee is whatever interest expense is recognised in respect of the lease liability, the limit of the deduction provided for by section 148G, plus the £100,000 (see new section 148GA(1)(c)(ii)).
    - A lessee has adopted IFRS 16 and has a long funding finance lease. At the end of year 5 the lease terms require the rentals to be adjusted based upon the movement of an index. This results in the lease liability and right-of-use asset being remeasured because the rental payments increase. The lease liability is increased by £100,000 and the right-of-use asset is increased by £100,000. The lease runs for another five years and the lessee depreciates the right-of-use asset on a straight line basis. New section 148GA provides that the deduction claimed by the lessee for each subsequent period of account after year 5 is whatever interest expense is recognised in respect of the lease liability, the limit of the deduction provided for by section 148G of ITTOIA 2005, plus the £20,000 depreciation charge which relates to the remeasurement (see new section 148GA(1)(c)(i)).

19. Paragraph 3 makes the changes to Corporation Tax Act (CTA) 2010, the most

significant of which are described below.

20. Paragraph 3(2) amends section 288 of CTA 2010 which concerns sale and leaseback arrangements, to ensure that the legislation continues to operate as intended. If the lessee uses IFRS 16 they must determine whether they would have accounted for any lease in respect of a right-of-use asset as a finance lease were they required under generally accepted accounting practice to determine whether the lease was a finance lease or not.

21. Paragraph 3(3) amends section 331 and inserts a new subsection 331(3)(da) of CTA 2010 to ensure that the rules continue to apply as intended to a lessee using IFRS 16.

22. Paragraph 3(5) inserts a new section 377A of CTA 2010. The new section applies in certain circumstances and will either increase or decrease the deduction claimed for corporation tax purposes for a lessee using IFRS 16 with a long funding finance lease. The new section identifies two circumstances where a lessee using IFRS 16 with a long funding finance lease will have a change in their rental payments. It allows an increased deduction based upon how any rental increase is reflected in its accounts or imposes a restriction of its deduction if the rental payments decrease.

23. New sections 377A(1)(a) and (b) provide that the section applies where the lessee uses IFRS 16, has a long funding finance lease and where there is a change in the rental payments in any period of account.

24. New sections 377A(1)(c)(i) and (ii) provide that the section only applies where the change in rental payments:

    - Results in a remeasurement of the lease liability in the lessee's accounts, or
    - Is recognised in the accounts as an amount paid under the lease but not as an amount accounted for as an interest expense that relates to a right-of-use lease nor as depreciation, or an impairment, of that right-of-use asset.

25. New section 377A(2) provides that where the section applies the lessee will adjust the deduction limitation under section 377 by the amount its accounting deduction in its profit and loss account is adjusted as a result of the change in rentals which meets the tests in new sections 377A(1)(c)(i) and (ii).

26. New section 377A(3) provides that there is no adjustment to the limitation under section 377 of CTA 2010 if the remeasurement or deduction results in enhanced capital expenditure provided for under section 70D of CAA 2001.

27. The two examples in paragraph 18 of this Explanatory Note apply equally as to the application of new section 377A as they do for new section 148GA of ITTOIA 2005.

28. Paragraph 3(6) amends the definition of a "long funding finance lease" in section 381 so that all lessees using IFRS 16 and who have a long funding lease will be defined as having a long funding finance lease. A new definition is inserted into section 381 of

CTA 2010 that defines a "right-of-use lease".

29. Paragraph 3(7) amends section 437, which concerns the sale of lessors. This change ensures that the legislation applies as intended for an IFRS 16 lessee, where the lease is a right-of-use lease.

30. Paragraph 3(8) inserts new subsections 544(5A) and (5B) of CTA 2010 amend the meaning of "property profits" and "property financing costs" for Real Estate Investment Trusts. This ensures that the legislation applies as intended for an IFRS 16 lessee, where the lease is a right-of-use lease.

31. Paragraph 4 amends section 494 of Taxation (International and Other Provisions) Act 2010 (TIOPA 2010) which sets out the definition of "finance lease" for the purposes of the Corporate Interest Restriction (CIR). This is to ensure that lessees as well as lessors continue to categorise leases into either finance leases or operating leases.

32. Where a lessee applies an accounting framework (such as FRS 102) that categorises leases into finance leases or operating leases, the rule is unchanged and that classification will be used for the purposes of Part 10 TIOPA 2010. Where a lessee applies an accounting framework (such as FRS 101 or IFRS) that does not apply such a categorisation, the lessee must still categorise the lease, if it is a right-of-use lease, for the purposes of Part 10 TIOPA 2010 as if it were required to do so for accounting purposes.

33. The reference in the definition to "right-of-use lease" ensures that where a lessee using IFRS 16 opts to keep a short-term lease or a lease of a low-value asset off the balance sheet, this lease need not be classified for CIR purposes – such leases are not included as "finance leases" under the CIR rules.

34. Paragraph 5 provides that the changes made by Part 1 of the Schedule will have effect in relation to periods of account beginning on or after 1 January 2019. For the purposes of chapter 7 of Part 10 TIOPA 2010 (which calculates certain figures of the worldwide group for CIR) the change made by paragraph 4 will have effect in relation to periods of account of the worldwide group beginning on or after 1 January 2019.

## Part 2: Long Funding Leases

35. Part 2 of the schedule makes changes to the long funding lease rules in Chapter 6A of Part 2 of CAA 2001.

36. Paragraph 7(1) amends section 70I. This extends the definition of a short lease from leases with a term of less than 5 years to leases with a terms of less than 7 years. It also omits subsections 70I(3) to (8) removing the conditions that made certain leases short leases if they had a term between 5 and 7 years.

37. Paragraph 7(2) makes consequential amendments that are needed to section 70YF.

38. Paragraph 8 amends section 70O which sets out the lease payments test and inserts a new section 70O(5). These changes amend the rate of interest used in the event the rate implicit in the agreement cannot be determined.

39. Paragraph 9 sets out that all of the changes in Part 2 will have effect in relation to leases entered into on or after 1 January 2019.

## Part 3: Changes to accounting standards and tax adjustments

40. Part 3 of the schedule governs the repeal of section 53 of FA 2011 and introduces new legislation to give effect to the new accounting standard IFRS 16. In particular it introduces rules that require a spreading of any transitional adjustment recognised upon adoption of the standard.

41. Paragraph 10 repeals section 53 of FA 2011. This will mean that unless the statute provides otherwise an IFRS 16 lessee can follow their accounts for tax purposes in respect of their leases. Previously section 53 would have meant that any changes to the accounting for leases (such as the new IFRS 16) would be ignored for tax purposes.

42. The repeal of section 53 will have effect in relation to periods of account beginning on or after 1 January 2019. However, for the purposes of chapter 7 of Part 10 TIOPA 2010 (which calculates certain figures of the worldwide group for CIR) the repeal will have effect in relation to periods of account of the worldwide group beginning on or after 1 January 2019.

43. Paragraphs 11 to 16 modify the change of basis provisions in Chapter 17 of Part 2 and Chapter 7 of Part 3 of ITTOIA 2005 and Chapter 14 of Part 3 and sections 261 and 262 of CTA 2009 where a lessee treats a lease as a right-of-use asset under IFRS 16 and had not previously accounted for the lease as a finance lease. These will have effect for a period of account beginning on or after 1 January 2019.

44. Paragraph 12 sets out the transitional adjustments required where an asset is first recognised in a period of account beginning on or after 1 January 2019. The calculation steps set out in paragraph 12 result in a lessee spreading all adjustments recognised in consequence of adopting IFRS 16 across the mean average length of the leases which have given rise to those adjustments.

45. Paragraph 12(1) sets out that the paragraph will apply when a lessee recognises an IFRS 16 lease in a period of account beginning on or after 1 January 2019.

46. Paragraph 12(2) sets out the steps that the lessee will use for any amount treated by any of the change of basis provisions as arising in consequence of a change of accounting policy in relation to the adoption of IFRS 16. The steps identify the amount to be recognised in a period of account and the period over which those amounts are recognised (“the spreading period”).

    - Step 1 requires the lessee to calculate the net debits and credits brought into account for each lease. The legislation ensures that the net amount includes only amounts recognised in equity which are in consequence of the transition to IFRS 16.

- Step 2 requires the lessee to calculate a percentage for each lease ("the relevant percentage") by dividing the amount under Step 1 for that lease by the total amounts for the lessee for all leases found under Step 1.

- Step 3 requires the lessee to multiply the relevant percentage found under Step 2 by the remaining period outstanding in days of the lease as at the date of transition. The term of a lease is determined in accordance with generally accepted accounting practice.

- Step 4 requires the lessee to calculate the mean of all periods under Step 3. This will be done by adding together all of the amounts calculated under Step 3.

- Step 5 sets out that the spreading period is the number of days found under Step 4 beginning with the day on which the first period of account begins.

47. Paragraph 12(3) requires an amount to be recognised in any period wholly or partly within the spreading period in proportion to the number of days falling within the spreading period.

48. Paragraph 12(4) provides that any amount calculated by paragraph 12 is also subject to paragraphs 14 and 15.

49. Illustrating these steps through an example, assume that the table below sets out details of four leases held by a lessee who adopts IFRS 16 on 1 January 2019.

| Lease | **Step 1** **Transitional accounting adjustment** | **Step 2** **Weighting percentage A/SUM ($A^1$-$A^n$)** | **Step 3** **Remaining lease term on IFRS 16 adoption** | **Step 4** **Mean lease period** |
|---|---|---|---|---|
| Lease 1 | £(10,000,000) credit | 26.32% (=10m ÷ 38m) | 1,826 days | 481 (=1826 × 26.32%) |
| Lease 2 | £8,000,000 debit | 21.05% (=8m ÷ 38m) | 730 days | 154 (=730 × 21.05%) |
| Lease 3 | Nil | Excluded | 1,826 days | Excluded |
| Lease portfolio | £20,000,000 debit | 52.63% (=20m ÷ 38m) | 1,461 days | 769 (=1461 × 52.63%) |
| **Overall** | **£18,000,000 debit** | **100%** | | **1,404 days** |

- Step 1 – Calculate the net debits and credits

  Calculation included in the table gives the figure of £18,000,000.

- Step 2 – Calculate the relevant percentage

  Calculation included in the table.

- Step 3 – Calculate the remaining lease term

  Calculation included in the table.

- Step 4 – Calculate the mean of all periods

  Calculation included in the table.

- Step 5 – Calculate the spreading period.

  The spreading period is 1,404 days.

- If the lessee had a period of account which ran from 1 January 2019 to 31 December 2019 they would claim as a deduction £4,679,487 (=365 ÷ 1,404 × £18,000,000).

50. Paragraph 13 provides that where a lessee has adopted IFRS 16 for a period of account prior to the first period of account the transitional provisions provided for in paragraph 12 have effect as if they arose in the first period of account beginning on or after 1 January 2019. This paragraph has the effect of ensuring that lessees choosing to early-adopt IFRS 16 are taxed on a basis consistent with lessees adopting IFRS 16 in the first period of account beginning on or after 1 January 2019.

51. Paragraph 14 provides for circumstances where a lessee has an amount that is being spread under the rules provided for by paragraph 12 and the lease is transferred to a connected party. The paragraph has the effect of requiring the transferee to continue to recognise the amounts that have been spread.

52. Illustrating paragraph 14 using an example:

- A lessee has computed a spreading period of 1,500 days and recognised a net debit of £1,000,000 under the computational steps provided for under paragraph 12. The first period of account ran from 1 January 2019 to 31 December 2019. On the $450^{th}$ day of the spreading period the lessee transfers all of the leases to a connected party.

- The transferor is 85 days into its period of account of 1 January 2020 to 31 December 2020 when it transfers the lease and will claim a deduction of £56,667 (=85 ÷ 1,500 × 1,000,000) in that period of account. The transferee has an identical period of account and will claim a deduction of £187,333 (=281 ÷ 1,500 × 1,000,000) in that period of account.

- The lessee will continue to spread the remaining transitional adjustment computed under paragraph 12 of £512,667 from 1 January 2021 over the remaining spreading period of 769 days.

53. Paragraph 15 provides for circumstances where the lessee has an amount treated under paragraph 12 and ceases its activities. The lessee brings into the account the remaining amount that has not been relieved immediately before the cessation.

54. Paragraph 16 provides that paragraphs 11 to 15 apply equally to lease portfolios as they do for individual leases.

55. Paragraph 17 provides that transitional adjustments following the repeal of section 53 of FA 2011 and the introduction of IFRS 16 shall be included in the list of the change of accounting provisions at section 426 of TIOPA 2010. This ensures that the transitional amounts are included in the calculations of group figures for CIR in circumstances where the group has made an interest restriction (alternative calculation) election.

56. Paragraph 18 provides the treatment under CIR of certain transitional adjustments arising on the repeal of section 53 of FA 2011 and the introduction of IFRS 16. In particular, it applies to adjustments where (i) they arises from a lease that was treated as a finance lease under the old accounting; and (ii) the company opts not to treat the leases as a giving rise to a 'right-of-use asset' as a result of it being a short term and low value lease. Such transitional amounts are treated as tax-EBITDA amounts (and not tax-interest amounts) in the CIR calculations.

# Background note

57. Entities applying IFRSs or FRS 101 will be required to adopt IFRS 16 for periods of account beginning on or after 1 January 2019 which will change the accounting treatment for leases. The main change will affect the treatment for the lessee.

58. Currently, lessees and lessors are required to make a distinction between finance and operating leases. Where the lessee has substantially all the risks and rewards incidental to the ownership of an asset (a finance lease) it recognises a finance lease asset and liability on its balance sheet. Where the lessee does not have substantially all the risks and rewards incidental to the ownership of the asset (an operating lease) it recognises lease payments as an expense over the lease term. This treatment will continue under the Financial Reporting Standard 102 (FRS 102), the main Financial Reporting Standard applicable in the UK and Republic of Ireland.

59. The new accounting standard will remove the distinction between finance leases and operating leases for a lessee. Going forward under IFRS 16 a lessee will recognise all leases on its balance sheet other than certain exempted leases which are of low value or are short term.

60. This measure introduces legislative changes to ensure that certain rules which relied upon the distinction between finance and operating leases will continue to operate as intended providing certainty and stability for businesses, and ensuring that taxation of lessees is broadly consistent regardless of which accounting framework is adopted.

61. Section 53 of FA 2011 was introduced in anticipation of these accounting changes but before the new accounting standard was settled. Section 53 has the effect of disregarding for tax purposes most changes in the accounting treatment for leases after 1 January 2011. This gave certainty to affected businesses, and permitted the government to consult fully over the future tax treatment of leases. However, it was

not intended to be a long term solution.

62. This measure repeals section 53 of FA 2011. This reduces the administrative costs for businesses by removing the requirement that a lessee, adopting IFRS 16 recalculate for tax purposes its lease accounting using the frozen accounting policy.

63. The long funding lease rules in Part 2 of CAA 2001 provide that where a plant or machinery lease is in substance a funding lease for the lessee (because the effect of the lease is substantially equivalent to the lessee having borrowed funds to acquire the asset) the lessee is entitled to claim capital allowances on the asset even though they are not the legal owner. The changes ensure that those rules will continue to apply as intended for an IFRS 16 lessee.

64. A lessee of plant and machinery using IFRS 16 will have a long funding finance lease if the lease is not short and it meets either the lease payments test or the useful economic life test. There is no need to distinguish between long funding operating leases and long funding finance leases for a lessee using IFRS 16 because all leases will be accounted for in the same way. Furthermore, this measure will ensure that a lessee using IFRS 16 with a long funding finance lease will be able to adjust the deduction claimed in certain circumstances where the rentals increase or decrease. The schedule makes several simplifications to the tests to identify a long funding lease which are not connected to the accounting standard changes.

65. The CIR rules operate to limit interest and other financing costs that are deductible for corporation tax purposes. These rules are consistent with the recommendations of Action 4 of the OECD's Base Erosion and Profits Shifting (BEPS) project. The OECD report recommended that the rules should apply to the finance cost element of finance lease payments. These changes to the legislation ensure that CIR continues to be consistent with the OECD's recommendations, and mean that any interest restriction will not vary significantly depending on the accounting framework used.

66. In particular, where a lessee has a right-of-use asset under IFRS the legislation will require the company to determine whether they would have accounted for the lease as a finance lease if they were required to determine whether the lease was a finance lease or not for accounting purposes. For leases classified as finance leases for tax purposes, any finance charges in the accounts are tax-interest amounts for CIR. For leases classified as operating leases for tax purposes, any finance charges in the accounts are not tax-interest amounts for CIR. Therefore lessees will not suffer any interest restriction on amounts paid in respect of operating leases.

67. Lessees can opt to apply several accounting options upon adoption of IFRS 16 and under some of those options it is expected that they will recognise a transitional adjustment in equity. Under the change of basis provisions that amount would be recognised in the period of transition. In addition the adoption of IFRS 16 may lead to certain other provisions being remeasured. It is expected that most entities adopting IFRS 16 and who choose an adoption method that recognises a net transitional adjustment will have a net debit. The spreading of that transitional adjustment for tax purposes over the average remaining term of the lessee's leases therefore protects Exchequer receipts whilst ensuring fairness for lessees regardless of which of the

accounting options they choose.

68. If you have any questions about the CIR change, please contact Jackie Phillips by telephone: 03000 564340 or email: interest-restriction.mailbox@hmrc.gsi.gov.uk

69. For all other questions please contact Ian Woodrow by telephone: 03000 589538 or email: ian.woodrow@hmrc.gsi.gov.uk