



HM Revenue
& Customs

Corporate Interest Restriction: Tax response to accounting changes for leasing

Summary of Responses
6 July 2018

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1. Executive Summary

- 1.1 Thank you to those who took part in the consultation *Corporate Interest Restriction: Tax response to accounting changes for leasing* published on 1 December 2017.
- 1.2 The consultation document set out three main options for legislative changes required to ensure the Corporate Interest Restriction ('CIR') rules in Part 10 Taxation (International and other Provisions) Act 2010 continue to work as intended, following the proposed repeal of section 53 Finance Act 2011 and the introduction of the new lease accounting standard, International Financial Reporting Standard 16 ('IFRS 16'), with a mandatory implementation date of 1 January 2019. The consultation asked for comments on the options presented.
- 1.3 The three main options presented and responses are summarised below:
 - Option 1: follow the accounting.** Although the simplest approach with the smallest compliance burden, this option was rejected by most respondents because it would result in different tax treatments depending on the accounting treatment adopted.
 - Option 2: distinguish between operating leases and finance leases.** The proposal was to require the lessee to ascertain the classification used by the lessor and to use that for CIR purposes. Respondents indicated that this would not be practicable but suggested a modified approach for lessees to make the classification themselves. The government is taking forward the suggested modified approach.
 - Option 3: distinguish between 'funding leases' and 'non-funding leases'.** This was based on the tests in the Capital Allowances plant and machinery rules. Respondents were concerned about the significant additional compliance burden and potential complexity of the rules.
- 1.4 The government is publishing draft legislation that will require companies adopting IFRS 16 or the equivalent Financial Reporting Standard 101 ('FRS 101') under UK Generally Accepted Accounting Practice ('GAAP') to continue to classify their leases as either 'finance leases' or 'operating leases' for the purposes of CIR.
- 1.5 Comments on the draft legislation should be emailed to: interest-restriction.mailbox@hmrc.gsi.gov.uk from the period 6 July 2018 to 31 August 2018.
- 1.6 Legislation is to be included in the next Finance Bill, to be effective from 1 January 2019.

2. Introduction

- 2.1 The Corporate Interest Restriction ('CIR') rules, enacted in Finance (No. 2) Act 2017 and effective from 1 April 2017, limit the net financing costs which a group can deduct against its UK taxable income. The rules reflect the recommendations of the OECD Base Erosion and Profit Shifting ('BEPS') project and the requirements of the EU Anti-Tax Avoidance Directive ('ATAD'). They apply to interest and amounts economically equivalent to interest, which the legislation refers to as 'tax-interest'. Under the current rules this includes the financing costs of 'finance leases' based on their accounting treatment.
- 2.2 The current rules assume that the accounting treatment that a company applies will require it to classify leases as either 'finance leases' or 'operating leases'. This, however, is not the case for a lessee company that adopts the new lease accounting standard IFRS 16. Users of International Accounting Standards ('IAS') are required to adopt IFRS 16 for periods starting on or after 1 January 2019. Users of FRS 101 will also begin to adopt the same treatment.
- 2.3 Section 53 Finance Act 2011 currently applies to negate any change in a leasing accounting standard for tax purposes. However, this was never intended to provide a long-term solution. Therefore, section 53 is to be repealed in the next Finance Bill with effect from 1 January 2019. This issue is referred to in the consultation *Leasing: Tax response to accounting changes* published on 1 December 2017, and its response document, published on 6 July 2018.
- 2.4 Given the repeal of section 53, the CIR rules need to be amended to accommodate IFRS 16. The government, therefore, published a consultation document on 1 December 2017 to consider how the CIR rules should be amended. That document is available at: <https://www.gov.uk/government/consultations/corporate-interest-restriction-consultation-on-leases>
- 2.5 The consultation sought views on three options for amending the CIR rules, bearing in mind the overall policy rationale for the CIR rules:
 - Option 1: Follow the accounting;
 - Option 2: Keep a distinction between operating leases and finance leases;
 - Option 3: Introduce a distinction between 'funding leases' and 'non-funding leases'.
- 2.6 The consultation also sought views on the need to introduce a special rule for intra-group leases that are short-term or in respect of low-value assets that may be exempted from the new 'on balance sheet' lease model under IFRS 16.
- 2.7 The consultation closed on 28 February 2018.

- 2.8 The government received 21 written responses and attended 9 meetings with interested parties to discuss the options outlined. Respondents welcomed the chance to engage with the government.
- 2.9 Many respondents suggested modifications to one or more of the options presented to either reduce compliance burden or to avoid disadvantaging certain sectors. This made the consultation particularly useful, and the government has taken the views expressed into account in designing the proposed solution.
- 2.10 This document contains:
- a summary of responses to the consultation; and
 - the government's proposed changes to the CIR legislation, taking into account the responses received.

3. Responses

- 3.1 The responses in relation to each of the three options are summarised here and a list of respondents is included in Annexe A.

Option 1: Follow the accounting

- 3.2 Under this option, where the accounting adopted by the lessee or lessor recognises a finance amount in respect of a lease, that amount would also be recognised as tax-interest within the CIR rules. Where no finance amount is recognised for accounting purposes, there would be no tax-interest pick up for CIR purposes.
- 3.3 This option would result in differing treatment for lessees depending on whether IFRS 16 or FRS 102 were adopted. An operating lease lessee under FRS 102 would not recognise a finance charge in its accounts and so would have nothing to bring in as tax-interest expense for CIR purposes. A lessee accounting for the same lease under IFRS 16 would recognise a finance charge in its accounts which would be brought in as tax-interest expense for CIR purposes.
- 3.4 The majority of respondents noted the potential simplicity and reduced compliance burden as the main advantage of this option. No other advantages were identified.
- 3.5 It was, however, also observed that this option might not be as 'simple' as it first appears. In particular, care would need to be taken where a different accounting framework is used at group level than at entity level. For example, additional rules would be needed to prevent an unfair outcome where a lessee group prepares consolidated accounts under IAS and entity level accounts under FRS 102.
- 3.6 Generally, respondents were not attracted to this option. They identified the following four disadvantages with this approach:
- 3.7 First, the tax treatment for lessees would depend on the accountancy standards/framework adopted. Respondents generally felt it would be inappropriate for the tax treatment of leases with the same commercial terms to be dictated by the accounting standards adopted. Some suggested that this could influence whether an entity chose to adopt IAS, while others pointed out that certain entities may have no choice and could find themselves disadvantaged as a result.
- 3.8 Second, adopting option 1 would be out of line with the recommendations of the OECD BEPS Action 4. Respondents emphasised that the final report stated, "...the rules set out in this report should not limit deductions for items such as... operating lease payments".
- 3.9 Third, it was generally considered that option 1 could result in an increased restriction for companies using IFRS 16, in particular those with substantial property leases. This would represent a significant change in the tax treatment for such businesses. Some respondents proposed that, should this option be taken, property leases should be wholly exempted from the CIR rules.
- 3.10 Fourth, this option could result in mismatches between lessor and lessee, both for intra-group leases and third party leases. Respondents expressed concern that a purely intra-group lease could produce a net tax-interest expense for a UK group – for

example if, under IFRS 16, the lessor classed the lease as an operating lease but the lessee had to include a finance charge in their accounts.

Option 2: Keep a distinction between operating leases and finance leases for CIR purposes

- 3.11 Under this option, tax-interest would include amounts where a lessee recognises a finance charge in relation to a leased asset. However, that finance charge would not need to be included in tax-interest where the lessor accounts for the lease as an operating lease and uses either FRS 102 or IFRS 16, and so does not recognise any finance income in respect of the lease.
- 3.12 The option as set out in the consultation required that the lessee ascertain that the lessor:
- prepares IAS or UK GAAP accounts, and
 - does not include any finance income in respect of the lease.
- 3.13 Respondents indicated that one of the main advantages of this option would be consistency of treatment under the CIR rules, regardless of the accounting framework adopted by the lessee. In addition, many noted that option 2 appeared to ensure that the treatment of operating leases for CIR purposes could largely remain the same following the introduction of IFRS 16.
- 3.14 Another advantage seen by many respondents was that option 2 could reduce mismatches in tax treatment between lessors and lessees, both intra-group and for third party transactions.
- 3.15 However, as presented, respondents did not consider this approach to be workable and they expressed serious concerns about the requirement for the lessee to establish the accountancy treatment adopted by the lessor. This was felt to create a large administrative burden for both lessees and lessors, and to introduce uncertainty in the tax compliance process of the lessee. Some respondents considered that the lessee could inadvertently submit incorrect tax returns if an accounting error was made by the lessor.
- 3.16 Respondents also emphasised that lessors may be unwilling to provide lessees with the required information, either because of the administrative burden or due to commercial sensitivity of the pricing of the lease.
- 3.17 Another area of difficulty identified was that lessors may not be required to produce accounts under IAS or UK GAAP, for example, if the lessor is an individual, a non-UK resident company, or simply exempt as a small company. Under the strict operation of option 2 as expressed in the consultation document, lessees would then be unable to exclude the relevant finance charges from tax-interest for CIR purposes, even if the lease would have been classified as an operating lease had the lessor prepared IAS or UK GAAP accounts.
- 3.18 The problems outlined above led many respondents to conclude that mismatches in treatment could still arise under option 2 where for any reason the lessee was unable to establish how the lessor had classified the lease in its accounts.

- 3.19 Several respondents suggested that option 2 could be modified to allow the lessee to determine how the lease should be classified, thereby removing the reliance on the lessor producing IAS or UK GAAP accounts and providing correct and timely information.

Option 3: Introduce a distinction between “funding leases” and “non-funding leases”, to be defined in tax legislation for CIR purposes

- 3.20 Under this option, instead of applying accounting classification rules, a company would apply tax rules in order to classify a lease. The proposal was to differentiate between a ‘funding lease’ and a ‘non-funding lease’, following the definition for Capital Allowances (section 70J CAA 2001). The CIR rules would apply this definition to all leases, not just plant and machinery leases.
- 3.21 The funding lease definition would contain three tests to be applied to all leases. If any of these were met, the lease would be a funding lease:
- Finance lease test;
 - Lease payment test; and
 - Useful economic life test.
- 3.22 For CIR purposes, where a lease is classified as a ‘funding lease’, the lessor would include finance income relating to the lease in tax-interest. The lessee would similarly include the finance charge relating to the lease in tax-interest. Where a lease is classified as a ‘non-funding lease’, no finance income or charge would be included as tax-interest for the lessor or lessee, respectively.
- 3.23 Around half of all respondents saw some advantages of option 3 over the other two options. In particular, several were attracted by the lack of reliance on the position of the lessor. This approach was also considered to give a consistent tax treatment for all lessees regardless of the accounting framework adopted.
- 3.24 Some respondents also commented that this option should ensure that the CIR rules would only apply to leases that are akin to finance arrangements, which would be consistent with the underlying policy objective of the CIR rules.
- 3.25 However, most of the respondents listed a number of disadvantages with option 3. The majority expressed concerns that this approach would create additional administrative and compliance burden for both lessors and lessees. This was felt to be particularly the case for entities with large lease portfolios and for groups with numerous overseas companies, which would also need to classify their leases using UK Capital Allowances rules under this option.
- 3.26 The apparent complexity of the tax tests under option 3 was also a concern reported by many respondents. Some felt that the funding lease rules are unfamiliar to a large number of taxpayers as their application is limited to plant and machinery. Respondents also indicated that the tests appeared to require judgement and could be subjective, introducing uncertainty into the compliance process.

Preferences expressed

3.27 Of the 21 respondents, 15 indicated a preference. As shown in the table below, the majority suggested some modification of one of the options or a combination of options.

<i>Stated preference</i>	Option 1	Option 2	Option 3	Modification	No preference	Total
<i>Number of respondents</i>	1	1	4	9	6	21

3.28 Of those who preferred a modified approach, two-thirds suggested a version of option 2 which placed less reliance on the treatment adopted by the lessor.

3.29 In light of the comments received, the government proposes that a modification of option 2 should be taken forward. Further details are set out in section 4 below.

Proposed treatment for intra-group leases that are short term or for low-value assets

3.30 As explained in the consultation document, under IFRS 16, lessees have an option not to use the 'on balance sheet' model for short-term leases or low-value assets. Where this option is used, it would mean that there would be no finance charge in the accounts of the lessee in respect of such leases. However, if the lessor classified such leases as finance leases, the lessor would continue to recognise finance income within tax-interest under the current CIR rules.

3.31 The proposal put forward in the consultation document was that where the lessee and lessor are in the same CIR group, if the lessee does not recognise a finance charge in its accounts in respect of a particular lease, the corresponding group lessor cannot include finance income from that lease within tax-interest for the CIR.

3.32 There were 8 responses on this point. Although some felt that this suggestion was a sensible one because it would eliminate mismatches without causing significant problems for groups, others expressed concerns regarding the additional administration burden for groups and questioned whether the risk to the Exchequer was sufficiently material to warrant the additional complexity for groups. In particular, respondents noted that the CIR rules already contain a Targeted Anti-Avoidance Rule ('TAAR') which should be sufficient to challenge intra-group arrangements that are put in place in order to achieve significant mismatches.

3.33 The government recognises the concerns raised and as a result has no current plans to include special rules to address cases where companies take the option to exempt certain leases from recognition on the balance sheet. The government will, however, monitor this situation.

4. Next steps

Government response

- 4.1 After consideration of the responses received, the government has decided to adopt a 'modified option 2' approach. Broadly, this should maintain the status quo.
- 4.2 The key element of this approach is that, for CIR purposes, leases will largely continue to be classified as either 'finance leases' or 'operating leases'. In particular:
- a) Lessees applying FRS 102 and all lessors will continue to use the classification that is required for accounting purposes to determine whether a lease is a 'finance lease' or an 'operating lease'.

Where a lease is a finance lease, the finance charge that is identified for accounting purposes will be included in tax-interest for CIR purposes, as is the case now. Where a lease is an operating lease, there is no finance charge to be included in tax-interest.

- b) Lessees applying IFRS 16 or FRS 101 will need to classify their leases as either 'finance leases' or 'operating leases' for CIR purposes, even though they do not need to do this for accounting purposes. They will be required to use a classification test that is equivalent to the one for FRS 102 and for IFRS 16 as it applies to lessors.

Where the lessee has a 'finance lease', the finance charge that is calculated for accounting purposes will be included in tax-interest for CIR purposes. Where there is an 'operating lease', any finance charge that is identified for accounting purposes is not included as tax-interest for the CIR.

- c) Where a company has taken the option under IFRS 16 or FRS 101 to exclude low-value and short-term leases from the application of 'on balance sheet' requirements, there will be no finance charge for accounting purposes. The company will *not* be required to calculate a finance charge for CIR purposes, even if that lease would have been a finance lease under FRS 102.
- 4.3 This approach largely maintains the classification prior to the introduction of IFRS 16, and is also consistent with the recommendations of the OECD BEPS Action 4 and the EU ATAD.
- 4.4 The proposed approach will not require companies to undertake actions that respondents considered to be particularly administratively burdensome, such as determining how the corresponding lessor classifies the same lease, or classifying all leases held by the worldwide group as either funding leases or non-funding leases.

Further consultation

- 4.5 Draft legislation to implement the government's proposed approach has been prepared and will be published on 6 July 2018.
- 4.6 The government invites comments on the draft legislation, to be sent either:

By email to – interest.restriction.mailbox@hmrc.gsi.gov.uk

By post to – Corporate Interest Restriction Team, Room 3C/04, 100 Parliament Street,
London SW1A 2BQ

- 4.7 The government currently expects to include legislation in the next Finance Bill.
- 4.8 The legislation is to be effective for periods of account commencing on or after 1 January 2019, to tie in with the repeal of section 53 Finance Act 2011.

Annexe A: List of respondents

	Name of Organisation
1.	Association of Convenience Stores (ACS)
2.	Association for Financial Markets in Europe (AFME)
3.	BP plc
4.	British Property Federation (BPF)
5.	British Vehicle Rental & Leasing Association (BVRLA)
6.	The Co-operative Group
7.	Debenhams plc
8.	Deloitte LLP
9.	Ernst & Young LLP
10.	Finance & Leasing Association (FLA)
11.	GLH Hotels Management (UK) Limited
12.	Grant Thornton UK LLP
13.	Invigors EMEA LLP
14.	KPMG LLP
15.	The Law Society
16.	M&G Prudential Investments
17.	Next plc
18.	PricewaterhouseCoopers LLP
19.	Royal Institution of Chartered Surveyors (RICS)
20.	The Rank Group Plc
21.	TUI (Touristik Union International) group