

# CORPORATION TAX ACT 2010

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## EXPLANATORY NOTES

### INTRODUCTION

#### **Part 21: Leasing arrangements: finance leases and loans**

#### **Chapter 2: Finance leases with return in capital form**

##### **Overview**

2663. This Chapter is concerned with finance leases intended to turn part of the associated rental income into capital receipts.

#### **Section 899: Arrangements to which this Chapter applies**

2664. This section describes the leasing arrangements that fall within Chapter 2. It is based on paragraphs 1(1) and 2(1) of Schedule 12 to FA 1997.

2665. The arrangements fall within the Chapter if they involve the lease of any property or rights (see *subsection (1)* and the definition of “asset” in section 937). Contrast Parts 9 and 20 which apply only to leases of plant or machinery.

2666. The Chapter is only capable of applying if two conditions are met. First, the arrangements must fall to be treated under GAAP as a finance lease or loan (see *subsection (2)*). Second, it is necessary that some or all of the lessor’s return on investment in respect of the finance lease or loan is not in the form of rent and would not, apart from this Part or Part 11A of ITA, be brought into account for tax purposes as rent (see *subsection (3)*).

2667. References to Part 11A of ITA and to tax purposes (rather than only corporation tax purposes) have been included in *subsection (3)* to ensure that the division between that Part of ITA and this Part works as intended.

2668. The Chapter is capable of applying to arrangements entered into before the commencement date of Schedule 12 to FA 1997 (see *subsection (4)(a)* and the commentary on section 923).

#### **Section 900: Purposes of this Chapter**

2669. This section sets out the main purposes of Chapter 2. It is based on paragraph 1(2) of Schedule 12 to FA 1997.

2670. The first purpose (in *subsections (2) to (4)*) is to substitute for the ordinary tax measure of income from the lease the amount recognised in accordance with GAAP where this is larger than the normal measure (see section 905).

2671. Under GAAP, part of the sum mentioned in section 899(3) is recognised as annual income over the course of the lease and thus taken into account in computing commercial profits. Income is recognised in this way because in substance the lease is

tantamount to a loan, the interest on which needs to be matched with the lessor's own borrowing costs in order properly to reflect the lessor's profit.

2672. The income recognised in accordance with GAAP may be that shown in consolidated accounts of the lessor's group or in those of a company which is a "connected person" of the lessor. The reason for looking wider than the lessor (see subsection (4)) is that the full earnings from the lease may only be shown in, say, the accounts of the parent or in the consolidated group results.
2673. The second purpose of Chapter 2 (in *subsections (5) and (6)*) is to recover appropriately any tax reliefs for capital expenditure already given.

### ***Section 901: Application of this Chapter***

2674. This section, together with section 902, determines whether Chapter 2 applies to a particular lease. It is based on paragraph 2 of Schedule 12 to FA 1997.
2675. For the Chapter to apply, the conditions in section 902 must have been met in relation to the lease at some time in a period of account of the current lessor (see *subsection (1) (b)*). But once they have been met in relation to the lessor at the time, they are treated as continuing to be met as regards any subsequent lessor unless and until the lease is assigned to a wholly unrelated person (see *subsections (3) to (5)*).
2676. *Subsection (2)* provides that the Chapter does not apply to long funding leases of plant or machinery in relation to which Part 2 of CAA gives capital allowances to the lessee instead of the lessor. The provisions rewritten in Chapter 2 of Part 9 of this Act set out the basis of taxation of rental earnings under such leases.
2677. *Subsection (6)* is a necessary consequence of the split into separate provisions for corporation tax purposes and income tax purposes.

### ***Section 902: The conditions referred to in section 901(1)***

2678. This section sets out the five conditions, A to E, all of which must be met if Chapter 2 is to apply to a specific lease. It is based on paragraph 3(1) to (5) of Schedule 12 to FA 1997.
2679. Condition A in *subsections (2) to (4)* requires the lease to fall to be treated under GAAP as a finance lease or loan.
2680. Condition B in *subsection (5)* requires a "major lump sum" which is not rent to be payable and for part of that sum to be treated under GAAP as return on investment in respect of the finance lease or loan.
2681. Condition C in *subsection (6)* is that not all of that part of the major lump sum would apart from Chapter 2 be brought into account for corporation tax purposes as the "normal rent" (see sections 896 and 903(3)) from the lease for accounting periods ending with "the relevant accounting period" (see section 903(1)).
2682. Condition D in *subsection (7)* is that for the period of account of the lessor in which "the relevant time" (see section 903(1)) falls or for an earlier period of account of the lessor, the "accountancy rental earnings" (see section 897) in respect of the lease exceed the normal rent for the period. The point of this condition is that, if a lessor is consistently being taxed on at least as much income as the commercial accounts show, then the terms of the lease are not ones which are designed to turn rental income into a capital receipt.
2683. Condition E in *subsection (8)* is that at the relevant time there exist such arrangements or circumstances as are mentioned in section 904.
2684. The arrangements and circumstances are set out in detail in section 904, but essentially there must be some likelihood that the lessee or a connected person of the lessee will buy out the lessor's interest in the leased asset for a major lump sum.

2685. Condition E is intended to ensure that a lease does not come within Chapter 2 solely because there is a possibility that the lessor may obtain a major capital sum otherwise than from the lessee or a connected person. This might happen for example on the unplanned sale of the leased asset to a third party or on a claim under an insurance policy on the destruction of the asset.

***Section 903: Provisions supplementing section 902***

2686. This section provides the meanings of “the relevant accounting period” and “the relevant time” and sets out how the normal rent is to be determined, for the purposes of section 902. It is based on paragraph 3(7) and (8) of Schedule 12 to FA1997.

***Section 904: The arrangements and circumstances referred to in section 902(8)***

2687. This section sets out the arrangements and circumstances which constitute Condition E in section 902(8). It is based on paragraph 4 of Schedule 12 to FA 1997.
2688. See the commentary on section 902.

***Section 905: Current lessor taxed by reference to accountancy rental earnings***

2689. This section provides for the lessor to bring into account for corporation tax purposes the accountancy rental earnings in respect of the lease for a period of account if they exceed the normal rent for the period. It is based on paragraph 5 of Schedule 12 to FA 1997.

***Sections 906 to 910: Reduction of taxable rent by cumulative rental excesses***

**Overview**

2690. These sections ensure that the rule in section 905 that the higher of the accountancy rental earnings and the normal rents (ordinary taxable rents) are taxed does not overall cause more rent to be taxed as income than is actually due to the lessor. They are based on paragraph 6 of Schedule 12 to FA 1997.
2691. These sections achieve their purpose by requiring running totals to be kept of aggregate differences between accountancy rental earnings and the normal rents. Any aggregate excess of accountancy rental earnings over normal rents arising in past periods can then be set against any current excess of normal rents over accountancy rental earnings. Conversely, any aggregate excess of normal rents over accountancy rental earnings arising in past periods can be set against any current excess of accountancy rental earnings over normal rents.
2692. The provisions of paragraph 6 of Schedule 12 to FA 1997 have been unpacked into five sections to provide greater clarity.

***Section 906: Reduction of taxable rent by cumulative rental excesses: introduction***

2693. This section introduces sections 907 to 910. It is based on paragraph 6(5) to(9) of Schedule 12 to FA 1997.

***Section 907: Meaning of “accountancy rental excess” and “cumulative accountancy rental excess”***

2694. This section defines the terms “accountancy rental excess” and “cumulative accountancy rental excess”. It is based on paragraph 6(3), (4) and (8) of Schedule 12 to FA 1997.

***Section 908: Reduction of taxable rent by the cumulative accountancy rental excess***

2695. This section applies if in relation to a lease for a period of account the normal rent exceeds the accountancy rental earnings (so it is the normal rent that is taxed) and there is a cumulative accountancy rental excess. It is based on paragraph 6(5) and (6) of Schedule 12 to FA 1997.
2696. The rent that is brought into account for corporation tax purposes is found by reducing normal rent by the cumulative accountancy rental excess but not so as to bring into account an amount less than the accountancy rental earnings for the period.

***Section 909: Meaning of “normal rental excess” and “cumulative normal rental excess”***

2697. This section defines the terms “normal rental excess” and “cumulative normal rental excess”. It is based on paragraph 6(1), (2) and (6) of Schedule 12 to FA 1997.

***Section 910: Reduction of taxable rent by the cumulative normal rental excess***

2698. This section applies if in relation to a lease for a period of account the taxable rent under section 905 would be the amount of the accountancy rental earnings and there is a cumulative normal rental excess. It is based on paragraph 6(7) and (8) of Schedule 12 to FA 1997.
2699. Section 905 only applies if the accountancy rental earnings exceed the normal rent. To avoid more rent being taxed as income for the period than is actually due to the lessor where there is a cumulative normal rental excess for the period, the rent that is brought into account for corporation tax purposes is found by reducing the accountancy rental earnings by the cumulative normal rental excess, but not so as to bring into account an amount less than the normal rent for the period.

***Sections 911 to 914: Relief for bad debts by reduction of cumulative rental excesses***

**Overview**

2700. These sections are concerned with bad debts. Broadly, the aim is to ensure that any bad debts are sensibly taken into account in calculating taxable profits and accountancy rental excesses and normal rental excesses. If the lease runs its course, the net rents taxed should equal the net rents payable after allowing for any bad debts.

***Section 911: Relief for bad debts: reduction of cumulative accountancy rental excess***

2701. This section deals with a bad debt deduction in respect of rent under a lease for a period of account if there is a cumulative accountancy rental excess for the period. It is based on paragraph 9(1) to (4) and (7) of Schedule 12 to FA 1997.
2702. *Subsection (2)* reduces the cumulative accountancy rental excess for a period where the accountancy rental earnings exceed normal rent by an amount equal to the excess of the bad debt deduction over the accountancy rental earnings.
2703. *Subsection (3)* deals with the converse situation if, for a period of account, normal rent is at least equal to accountancy rental earnings (so that it is the normal rent which is taxed). In those circumstances there are two restrictions.
2704. *Subsection (4)* provides that relief otherwise available under section 908(2) in a period for any cumulative accountancy rental excess brought forward from previous periods is restricted to any excess of the normal rent over any bad debt deduction given in respect of rents from the lease. That is because only the normal rent net of bad debt relief is in effect being brought into account for tax.

2705. *Subsection (5)* applies if the bad debt deduction exceeds the normal rent for a period of account. In such a case any cumulative accountancy rental excess brought forward from previous periods is reduced by the amount by which the bad debt deduction exceeds the normal rent. That is because the excess of the bad debt deduction over the normal rent for the period of account already represents relief for rents taxed in previous periods.

***Section 912: Recovery of bad debts following reduction under section 911***

2706. This section reinstates any relief for cumulative accountancy rental excess reduced under section 911 if the bad debt deduction is subsequently reversed (because the debt is recovered or prospects for its recovery improve). It is based on paragraph 9(5) to (7) of Schedule 12 to FA 1997.

***Section 913: Relief for bad debts: reduction of cumulative normal rental excess***

2707. This section deals with the interaction of bad debt deductions and relief for cumulative normal rental excess under section 910. It is based on paragraph 10(1) to(4) and (7) of Schedule 12 to FA 1997.
2708. As with section 911, the rationale is that the relief should only represent an excess of normal rent over accountancy rental earnings which have effectively been brought into account for tax and that the relief should only be given against rents similarly brought into account.
2709. The structure of the detailed rules is identical with that in section 911.

***Section 914: Recovery of bad debts following reduction under section 913***

2710. This section reinstates any relief for cumulative normal rental excess reduced under section 913 if the bad debt deduction is subsequently reversed (because the debt is recovered or prospects for its recovery improve). It is based on paragraph 10(5) to (7) of Schedule 12 to FA 1997.

***Section 915: Effect of disposals of leases: general***

2711. This section treats a period of account of the lessor as coming to an end for the purposes of this Part immediately before any disposal of the lessor's interest under the lease, the leased asset or an asset representing the leased asset. It is based on paragraph 12(5) to (7) of Schedule 12 to FA 1997.
2712. This enables the cumulative accountancy rental excess or the cumulative normal rental excess for the period of account of the lessor that then begins, and in which the disposal takes place, to be calculated.
2713. The remaining sub-paragraphs of paragraph 12 of Schedule 12 to FA 1997 are rewritten as section 37A of TCGA by Part 2 of Schedule 3 to TIOPA. See the commentary on that Schedule to TIOPA. *Subsection (5)* provides a signpost to that section.

***Section 916: Assignments on which neither a gain nor a loss accrues***

2714. This section deals with the assignment of a lease in circumstances which are regarded for the purposes of corporation tax on chargeable gains as giving rise to neither a gain nor a loss. It is based on paragraph 7 of Schedule 12 to FA 1997.
2715. Paragraph 7(2) of Schedule 12 to FA 1997, on which *subsection (2)* is based, provides for a period of account of the assignor to end and a period of account of the assignee to begin with the assignment.
2716. Paragraph 7(3) of Schedule 12 to FA 1997 provides that the assignee takes over the assignor's "unused cumulative accountancy rental excess" or "unused cumulative normal rental excess".

2717. These “unused” cumulative excesses are the aggregate of the cumulative rental excess for the period of the assignor which ends with the assignment and any rental excess for that period.
2718. But the combined effect of section 915(2) (based on paragraph 12(5) of Schedule 12 to FA 1997) and subsection (2) is that the period of account of the assignor which ends with the assignment is infinitesimally short. There can, therefore, in practice be no accountancy rental excess or normal rental excess for that period.
2719. Accordingly, in rewriting paragraph 7(3) of Schedule 12 to FA 1997 in *subsections (3) and (4)*, the provision has been simplified by referring only to the cumulative accountancy rental excess or the cumulative normal rental excess for that period.
2720. *Subsection (5)* ensures that the division of the income tax provisions in Part 11A of ITA and the corporation tax provisions in this Part works as intended.

### ***Sections 917 to 922: Capital allowances: clawback of major lump sums***

#### **Overview**

2721. These sections unpack paragraph 11 of Schedule 12 to FA 1997 to improve its accessibility.

#### ***Section 917: Effect of capital allowances: introduction***

2722. This section introduces sections 918 to 922 and provides that they apply if a major lump sum (see section 902(5)) falls to be paid in relation to a lease. It is based on paragraph 11(1) and (2) of Schedule 12 to FA 1997.

#### ***Section 918: Cases where expenditure taken into account under Part 2, 5 or 8 of CAA 2001***

2723. This section deals with capital allowances in respect of plant or machinery, mineral extraction and patent rights. It is based on paragraph 11(3) to (7) of Schedule 12 to FA 1997.
2724. *Subsection (2)* brings into account as disposal value for the purposes of CAA an amount equal to the amount or value of the major lump sum. This is subject to adjustment under *subsections (3) to (6)* if the disposal value is limited in accordance with CAA.

#### ***Section 919: Cases where expenditure taken into account under other provisions of CAA 2001***

2725. This section deals with capital allowances given under any provision of CAA other than those mentioned in section 918. It is based on paragraph 11(8) and (14) of Schedule 12 to FA 1997.
2726. In these cases, an amount equal to the allowances given or, if less, the amount or value of the major lump sum is treated as a balancing charge.
2727. Following the repeal of section 532 of ICTA by CTA 2009, the extended definition of the Capital Allowances Act in paragraph 11(14) of Schedule 12 to FA 1997 is otiose and has not been rewritten.

#### ***Section 920: Capital allowances deductions: waste disposal and cemeteries***

2728. This section deals with deductions for capital expenditure allowed under section 142, 145 or 147 of CTA 2009. It is based on paragraph 11(11) and (12) of Schedule 12 to FA 1997.
2729. In these cases, an amount equal to the deductions allowed or, if less, the amount or value of the major lump sum is treated as a trading receipt.

***Section 921: Capital allowances deductions: films***

2730. This section deals with deductions in respect of films allowed under section 40B(1) or 42 of F(No 2)A 1992. It is based on paragraph 11(9) and (10) of Schedule 12 to FA 1997.
2731. In these cases, if the amount or value of the major lump sum exceeds so much of that sum as was treated as a receipt of a revenue nature under section 40A(2) of F(No 2)A 1992, the excess is also treated as a receipt of a revenue nature.

***Section 922: Contributors to capital expenditure***

2732. This section deals with the case where capital allowances have been made to a person making contributions to capital expenditure on the provision of a leased asset under sections 537 to 542 of CAA. It is based on paragraph 11(13) of Schedule 12 to FA 1997.
2733. *Subsection (2)* provides that sections 918 and 919 have the same effect in relation to the contributor and those allowances as they do in relation to the lessor and allowances given to the lessor for such expenditure by the lessor.

***Section 923: Pre-26 November 1996 schemes where this Chapter does not at first apply***

2734. This section makes provision for recognising income from some finance leases which form part of a “pre-26 November 1996 scheme” as defined in section 930(1)(a). It is based on paragraph 13 of Schedule 12 to FA 1997.
2735. A lease which forms part of a pre-26 November 1996 scheme only falls within this Part if it meets all the conditions in section 902. It does not fall within Chapter 3 as that Chapter only applies to leases which do not form part of a pre-26 November 1996 scheme (see section 927(1)(b) and the definition of a post-25 November 1996 scheme in section 930(1)(b)).
2736. If a lease forming part of a pre-26 November 1996 scheme met all the conditions in section 902 on 26 November 1996, it falls within Chapter 2 for all periods of account beginning, or treated under section 932 as beginning, on or after that date, subject to section 901(3).
2737. But such a lease may not meet all those conditions until after 26 November 1996. In that case, this section effects a catching up exercise by taxing under section 905 in the period when the lease is first subject to the rules in Chapter 2 the accumulated excess (if any) of the accountancy measure of income from the lease over the income actually taxed in earlier periods. No such excess relating to periods prior to 26 November 1996 can be taxed in this way nor are the assessments for earlier periods of account actually re-opened. The catching up is done in the period in which the conditions are met.
2738. *Subsection (3)(b)* provides that for the purposes of this Part the time when the conditions are satisfied forms its own brief period of account. This ensures that the computational provisions in this section work correctly.
2739. *Subsection (10)* provides for the case where for example there has been an assignment within section 916 and the lessor at an earlier time was within the charge to income tax.

***Section 924: Post-25 November 1996 schemes to which Chapter 3 applied first***

2740. This section provides continuity of reliefs when a lease changes status. It is based on paragraph 14 of Schedule 12 to FA 1997.
2741. It applies if a lease which is initially subject to the rules of Chapter 3 subsequently comes within those of Chapter 2. Any cumulative accountancy rental excess or any cumulative normal rental excess for the purposes of Chapter 3 counts for the purposes of Chapter 2.

*These notes refer to the Corporation Tax Act 2010  
(c.4) which received Royal Assent on 3 March 2010*

2742. *Subsection (4)* provides for the case where for example there has been an assignment within section 916 and the lessor at an earlier time was within the charge to income tax.