Leasing: Tax response to Accounting changes

Submission from:

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INTERNAL

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Executive Summary

1. The British Vehicle Rental and Leasing Association (BVRLA) welcomes the opportunity to comment on HM Revenue and Customs (HMRC) consultation on ensuring tax works for the new lease accounting standard IFRS16 and on the wider tax impact.

2. We are grateful to be able to meet with HMRC and for the opportunity to highlight areas we believe would ensure the UK has a progressive tax system that is simple, fair and helps to support the Government's industrial and environmental strategy and associated policy objectives. It is critical that the taxation system is designed to support and incentivise Government's wider policy objectives. This will allow BVRLA members to support their delivery most effectively.

3. Our members take a keen interest in the "clean growth agenda" and with the appropriate regulatory and economic environment, they are ideally placed to be able to support the Government in meeting its objectives.

4. The vehicle rental and leasing sector plays a vital economic and environmental role in helping UK firms and individuals access the greenest and cleanest vehicle technology. Our research shows:-

   - BVRLA leasing car fleet is 23% greener than the UK average car parc
   - The sector operates 1 in 8 cars and 1 in 5 commercial vehicles on UK roads
   - 320,000 UK jobs are supported by our sector
   - £25 billion annual contribution is made by our sector to the UK economy
   - 80% of cars that are UK built and sold in the UK are purchased by our members
   - 1 million vehicles purchased annually

Our submission focuses on three key areas: -

- Clarity on the proposed rules and transitional arrangements
- Simplification on the tax treatment of motor vehicle leases
- Modernising the current tax rules to support the Government's industrial and clean growth strategy

Tax on Leases

5. **Summary of Proposed Changes**

   We note that the consultation applies to plant and machinery, including motor vehicles.

6. **UK GAAP Companies (FRS 102)**

   - Current tax rules apply
   - For long funding leases this means the lessee obtains capital allowances

7. **IFRS 16 Companies (& FRS 101)**

   - For leases not classified as long funding leases (i.e. short leases) tax relief is available to lessees based on the right of use (ROU) asset (i.e. depreciation and interest)
   - For long funding leases the lessee will obtain capital allowances based on the ROU asset

8. **Short Leases / Long Funding Leases**

   - Proposal that all leases of 7 years or less are classified as short leases
   - For leases over 7 years various tests are proposed to determine whether a lease is defined as a long funding lease, meaning one or more of the following conditions apply:
   - Substantially all the risks and rewards of ownership are transferred
   - The present value of minimum lease payments is equal to or greater than 80% of the fair value of the asset
   - The term of the lease is more than 65% of the remaining useful life

9. **Transitional Arrangements**

10. We support the aims behind the planned changes; but we would add caution in how the changes are made to help avoid any unintended consequences. We specifically wish to ensure the changes do not create any undesired market disruption or tax revenue distortion.

11. We also believe that compliance burdens should be kept to a minimum and support businesses leasing assets by ensuring they are not expected to carry out complex and technical tax computations.

12. On transition, we note the proposal is that for tax purposes the ROU asset is to be treated as equal to the corresponding liability. Where IFRS 16 reporting companies elect to treat the ROU asset not equal to the corresponding liability on transition, this creates an inconsistency between tax and accounting. Hence this will create the need to maintain two sets of records, absent any relief. The resource to support and practical consequences must not be underestimated. In particular, where asset numbers are other than de minimus, individual assets will need to be tracked to ensure movements are appropriately reflected.

13. Indeed, IFRS 16 allows preparers a myriad of options available. To allay concerns outlined in paragraph 12 above, and for the sake of simplicity and avoidance of having to keep separate records for tax purposes, we propose an alternative option for tax purposes. This would be to allow preparers to follow the accounts and any difference between ROU asset and lease liability on transition recognised straight line over the life of the lease or indeed, the related portfolio where comprising assets which share common characteristics. If there was any tax benefit we would expect it to be minimal. This approach would provide significant practical relief.

14. From our recent meeting with HMRC, we understand accruals and prepayments will be taken into account on transition and therefore "appropriate" tax relief will be obtained, nevertheless confirmation of this will be helpful.

15. Taking into account lease payments in advance for transition purposes is welcomed as this would otherwise lead to a potential tax recovery issue as relief is given based on the liability which may have a different value to ROU asset.

16. BVRLA welcomes the simplification of the definition of short leases. This is likely to provide a positive boost to the leasing industry allowing commercial vehicles to be funded on contract hire over longer periods. Hitherto, the long funding lease rules acted as a constraint.

17. We would welcome clarification that if a seven-year lease vehicle is contract amended mid contract, to formally extend by a further year, this would still be considered as a short lease, on the premise that the contract amend is due to a change in circumstances, rather than being planned at inception.

18. Clarity

19. We also assume that the Right of Use (ROU) asset is equivalent to the finance (reflecting the capital & interest) element of the lease payment / liability being paid today. In other words, the ROU assets should the present value lease payments that represent capital and interest initially.

20. There is no reference to lease rental restriction (LRR) in the consultation. In our submission we call for LRR to be removed entirely, but nevertheless we feel there needs to be clarity on how this will work for IFRS reporting companies if retained.

21. At present this is based on a restriction of a part of the finance rental, whereas for consistency with ROU asset an alternative would be to base this on depreciation. Or would the expectation be that the depreciation and lease interest is reduced proportionately?

22. There is also no reference to 100% first year allowance for ultra-low emission vehicles (ULEV), which was previously available to lessors of vehicles purchased before 1 April 2013. At present this is only available for customers who acquire qualifying vehicles via hire purchase, contract purchase or outright purchase but not via leasing. This treatment discriminates against leasing as denying the lessor the allowance will make the lease rental higher than it otherwise would be. If the lessor could claim the allowance, this benefit could be passed on to the lessee by way of lower rental payments. In some cases, leasing is the only way in which the user might be able to access an asset – it may not have the credit history to support borrowing or may not have cash reserves. In which case the user may opt for a less “green” vehicle that is more affordable.

23. As you will note tax does influence the form of financing for greener cars. We believe as a principle, that tax should be neutral as far as the preparer is concerned in determining how to acquire an asset.

24. Consequences

25. The consultation represents a practical attempt to ensure consistency between UK GAAP and IFRS reporting organisations as far as possible and to simplify long funding lease rules by proposing all leases of 7 years’ duration or less are classified as short leases.

26. Whilst the objective is consistency (& stability with the current tax regime) there does appear to be a difference in the treatment of long funding leases, since UK GAAP reporting organisations will obtain capital allowances based on the fair value of the leased asset, whilst IFRS reporting organisations will obtain tax relief on the ROU asset which is a discounted value (present value of rentals) and therefore could be different. Again, we would expect taxation to be independent of the accounting standards followed – the right of use asset could be, for example, as low as 80% of the fair value of the asset.

27. By taking into account payments in advance on transition a potential tax recovery issue appears to have been addressed. The consultation proposes for tax purposes that on transition the ROU asset is to be treated as equal to the corresponding liability. Without taking into account prepayments, any lessee that makes rental payments in advance would otherwise suffer a loss of tax relief since the value of the liability would be less than the ROU asset.

28. For IFRS reporting companies obtaining tax relief on short leases via depreciation and interest based on the ROU asset is a practical solution since this will mirror the lessee accounting treatment. However tax relief will differ with UK GAAP reporting companies who will still obtain tax relief on rental payments.

Election under SI 2007/304

29. As HMRC is aware, the BVRLA supports the Office of Tax Simplification (OTS) review of capital allowances as we believe vehicle lessors should be able to claim tax relief based on accounting depreciation. While we understand that the Chancellor will review the recommendations reached by the OTS in due course, we are urgently calling for SI 2007/304 to be amended to allow cars to be eligible assets for the long funding lease treatment. This would simplify the tax treatment and provide cost savings which could be passed on to lessees.

30. Vehicle depreciation is the single biggest cost to a vehicle lessor and the deferral of corporation tax relief through the application of capital allowances adversely affects cash flow and can distort pricing strategies as lessors of different sizes and tax circumstances seek to offset this situation. Some members report that this can often mean tax relief is being sought for vehicles for a period of 20 years or more, long after the vehicle has been sold.

31. UK car lessors continue to face lengthy deferrals on the tax relief for expenditure on cars, especially those that fall into the special pool. The rules are penal to lessors who are simply fulfilling an order placed by their customers and we would suggest it would be far simpler and effective from a behavioural perspective to follow the principle of the polluter, and only the polluter, pays as reflected in existing taxes such as VED and company car tax.

32. Lessors of plant and machinery today have a right of election so that the eligible assets can be treated as though they were long funding leases[1], for the purposes of Part 2 of the Capital Allowances Act. As currently drafted, cars are excluded from being eligible assets for the purposes of this election, and we are asking for this exclusion to be removed as it is discriminatory towards customers leasing cars. We see no policy reason for the continued exclusion of cars.

33. The effect of the election is that a lessor can deduct the accounting depreciation on such assets. There is no need to track each asset separately in order to calculate a balancing adjustment on sale. The right of election has no effect on the tax treatment of the lessee and once an election is made it helps to vastly reduce tax calculations placed on lessors.

[1] See Condition F in Paragraph 3 of SI 2007/304
http://www.legislation.gov.uk/uksi/2007/304/pdfs/uksi_20070304_en.pdf

34. Removal of this restriction would help to reduce tax compliance costs as tax returns would become simpler for the reasons identified above. Separate asset pools for tax would no longer be required; tax relief would become more comprehensible and related operating risks eliminated.

35. Tax would be further simplified as there would be no timing differences between capital allowances and depreciation, thereby removing deferred tax accounting for cars. This would allow a more comparable picture of the tax "written down" value and the actual market value of a car at the end of the lease. This would allow a fairer representation of its economic value in use.

36. **Action Requested – Amend SI 2007/304 to remove Condition F and allow cars to be eligible assets.**

Lease Rental Restrictions

37. The current lease rental restrictions (LRR) for income tax and corporation tax, which prevent businesses leasing a car emitting more than 130 g/km CO_2 (reducing to 110 g/km CO_2 in April 2018) from claiming full tax relief, should be removed. We note that lessors continue to be taxed on the "full rental" and hence there is asymmetry.

38. **Environmental Incentive** – The LRR's historical aim of incentivising customers to select greener cars is proving to be ineffective and a blunt instrument. Customers leasing cars are being influenced by existing environmental taxes, such as company car tax and VED which are better understood and play a visible role in influencing car choice.

39. Leasing is a very cost driven competitive market. Net cost has a major influence on a drivers' selection for green cars. By net cost we mean the 'premium' in the monthly rental associated with a greener car compared to its polluting competitor versus savings to be realised in lower monthly running cost.

40. In many cases, a more polluting car will produce a cheaper net cost, particularly with the group of cars that are not 'green' but not high polluters either. The premium in monthly rental is a result of the higher purchase price associated with green cars (at a very high level the rental is equal to purchase price to lessor plus some profit margin spread over lease term). Availability of charging points, and general convenience of fuelling is also a factor.

41. **Regulatory burden & added tax complexity** - The lease rental restrictions simply add an unnecessary layer of regulatory and administrative tax complication with no corresponding benefit or environmental gain.

42. To clarify, the vast majority of taxpayers do not have dedicated resource to manage this compliance burden and it falls on the shoulders of the finance department. While it is difficult to allocate a specific cost to corporation tax reporting, or more specifically the lease rental restriction, however it is fair to say that calculating and reporting this restriction either requires the customer to effectively maintain a separate record of such assets of or to pay a leasing company to report this book to them on a periodic basis. Costs incurred to manage this are obviously tax deductible.

43. **Tax should not influence financing decision** - The current lease rental restrictions are discriminatory towards firms that choose to lease their business cars, and a good example of tax distorting financing decisions. We support the approach that environmental taxes should be paid irrespective of the acquisition method used i.e. outright purchase, HP or conditional sale finance agreement. Doing so will help to deliver fairness and parity between all funding choices for firms wishing to use a greener vehicle on their business fleet.

44. **Protection for the Exchequer** - We recognise the importance of maintaining prudent and sound public finances and therefore suggest that any tax loss is recovered from all business car users irrespective of the method of acquisition. For example, existing environmental motoring taxes such as VED or company car tax should be used instead. In doing so, the exchequer is also protected by not being reliant on leasing to recover this tax revenue.

45. **Action Requested – Remove the Lease Rental Restrictions in s48 ITTOIA 2005 and s56 CTA 2009.**

First Year Allowance (FYA)

46. **Affordable access to EVs** - To enable the UK to deliver these ambitious goals and develop a road to zero emission targets, the UK Government should, at the first available opportunity, enable customers leasing their electric fleet to benefit from lower monthly bills. If leasing firms are excluded from being able to claim the FYA, then these savings cannot be passed on to customers and attract new customers to use an electric vehicle.

47. Support Governments Clean Growth and Industrial Strategy – To attract investment into the UK's motoring sector, and to ensure the UK is seen as a centre of excellence for greener technology, excluding UK leasing firms from being able to claim FYA is a real missed opportunity, especially as this sector can play a significant role in helping UK motorists to access greener motor vehicles.

48. If vehicle lessors were able to claim FYA, this would narrow the gap between the cost of leasing and outright purchase and hence a fairer market would evolve, and businesses would be more likely to lease rather than purchase outright.

49. In environments where financial resources are limited and increasingly under strain, allowing UK lessors to claim FYA would help to "add value" by encouraging businesses to adopt greener vehicles which would help to generate new income streams and hence to increase future taxable income for the Exchequer.

50. Moreover, we believe that this would create a significant increase in demand for greener vehicles – this, in turn, would support the business case for green technology and lead to greater investment. The result: more effective/efficient vehicles but also potential by-products relevant to other industries. Ultimately, supporting the UK's contention that it become a centre for and leader of green technology.

51. **Action Requested – reinsert the reference to "section 45D" in s46 (5) CAA 2001 that was removed by s68 (2) FA 2013.**

Summary of Key Recommendations

Lease Accounting Changes

Transitional Arrangement – Avoid undesired market or tax revenue distortion.

Clarity - Is ROU asset equivalent to the finance payment? How will LRR be treated?

Consequence - To ensure tax parity is maintained between IFRS 16 and UK GAAP firms

Lease Rental Restriction – remove this out-dated tax restriction on leasing

Election – amend tax rules to allow car lessors to use accounting depreciation instead of claiming capital allowance and thereby securing parity with lessors of other asset

First Year Allowance – Allow UK car leasing firms to claim green car tax relief

Closing comments

52. The BVRLA welcomes the opportunity to comment on the planned tax changes. We use this opportunity to make a series of recommendations which have the duel objective of modernising the current tax system and support the Government's industrial & clean growth strategy. Other benefits include:

    - The cost of managing separate "tax pools" and related risks would be eliminated.
    - Tax allowances would be better understood/appreciated with relief given over the preparer's period of ownership, benefiting lease pricing.
    - Resource would be freed up, allowing it to be redirected to other business areas and encouraging business/taxable profit growth.

53. The BVRLA appreciates that these issues are a detailed and would be happy to provide any additional information or clarification on any of the points presented as part of this submission, or to present our views in person to any relevant official(s), to help support our submission.

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About the BVRLA and its members

- Established in 1967, the British Vehicle Rental and Leasing Association is the UK trade body for companies engaged in the rental and leasing of cars and commercial vehicles. Its members operate a combined fleet of over 4.9 million cars, vans and trucks.
- BVRLA members purchase nearly 50% of all new vehicles sold in the UK, an estimated 1 million vehicles per annum, including an estimated 80% of all cars built and sold in the UK.
- Collectively, members of the BVRLA support around 317,000 jobs and contribute over £24.9 billion to the UK economy each year.
- Through its members and their customers, the BVRLA represents the interests of over 2 million business car drivers and 10 million people per year who choose to rent a vehicle.
- As well as informing the Government and policy makers on issues affecting the sector, the BVRLA regulates the industry through a mandatory code of conduct, helping its members deliver safe, sustainable and affordable road transport to millions of consumers and businesses. For more information, please visit www.bvrla.co.uk.