

Long Funding Leases

Impact on Fixtures in Property



Background

Legislation was introduced in Finance Act 2006 to determine the taxation treatment of certain plant or machinery leasing transactions. The new rules apply to what are known as “long funding leases” of plant and machinery and are relevant for both income tax and corporation tax.

HMRC have taken the view that such leases are essentially financing arrangements and the legislation operates to treat the lessee as if they had borrowed money to buy the plant or machinery. For capital allowances purposes, it is the lessee under a long funding lease who is entitled to allowances.

What is a long funding lease?

In order to determine whether the new rules apply to a plant and machinery lease, it is necessary to establish if it is both a “funding lease” and a “long lease”.

A funding lease is one that is either:

- a) accounted for as a finance lease or loan under GAAP
- b) where the present value of the minimum lease payments under the lease is equal to or greater than 80% of the fair value of the leased plant, or
- c) where the term of the lease is more than 65% of the remaining useful economic life of the asset.

Having established that the lease is a funding lease, then it will be treated as a “long funding lease” if it is not classified as a short lease. A short lease is defined as a lease with a term of no more than five years, although a lease will also be deemed to be short if all of the following conditions apply:

- a) the lease is between five and seven years
- b) it is a finance lease
- c) the residual value in the lease is not greater than 5% of the market value of the plant at the commencement of the lease
- d) the rentals due in any year do not vary by more than 10% from the rentals due in any other year

Plant and machinery fixtures in buildings

It is possible that plant and machinery leased with a building could fall within the new leasing rules where the lease term is more than five years. This would result in any capital allowances on the inherent plant being unavailable to the lessor. However, all is not lost as HMRC have made an exemption for what is described as “background” plant and machinery typically leased with a building.

Definition of background plant or machinery

The Treasury issued a statutory instrument (SI2007/303) which provides a description of the type of plant and machinery that may be regarded as falling within the definition of “background plant or machinery” for the purposes of the long funding lease regime. The examples of background plant or machinery given include:

- heating and air conditioning installations (including plenum ceilings)
- hot water installations
- electrical power installations, switchgear, etc.
- mechanisms, including automatic controls for opening doors, windows and vents
- passenger lifts and escalators
- window cleaning installations
- various fittings such as cupboards, blinds, curtains, carpets, demountable partitions
- protective installations
- building management systems

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A separate list of items, which are definitely to be treated as background plant, is also provided. This list includes, sanitary and welfare fittings, computer networking facilities, kitchen equipment, seating, signs, PA systems and security alarms.

Interestingly, lighting installations are also included in the list of background plant even though they may not qualify for capital allowances at all if they are not specifically designed to meet the requirement of the trade being carried on.

Impact on property transactions

Typically, all landlord installed plant and machinery fixtures inherent in an office building or industrial facility would meet the conditions for background plant and machinery. It is usually the tenant who will incur direct expenditure in fitting out the premises to suit the trade. However, where the landlord makes a contribution towards the cost of a tenants fit out (which is most common in the case of retail premises), this does give rise to a potential issue for the landlord whereby the new rules may prevent them from claiming capital allowances.

If such a contribution is not accounted for as part of the leasing income for the landlord, then it may be concluded that the contribution is not caught by the new leasing rules and any plant or machinery would attract normal contribution capital allowances.

However, if the contribution is accounted for by the landlord in arriving at net leasing income and the plant or machinery to which the contribution relates is excluded from background plant then the new rules may preclude a claim for capital allowances.

As an example, if a landlord incurs expenditure on plant and machinery used for storage or subjecting goods to a process which are items specifically listed in SI2007/303 as **NOT** background plant or machinery, then he would not be allowed to claim capital allowances under the new regime if the plant is leased with the building.

There is a *de minimis* amount of such expenditure which will not be caught by the new long funding lease rules and in cases where the value of this type of NON background plant is low in value compared to the lease or the land with which it is leased, notwithstanding the fact that the plant may not meet the definition of background plant and machinery it may still be treated as such.

The exemption is met if:

- the anti avoidance rules relating to background plant and machinery do not apply
- the market value of non background plant and machinery does not exceed 10% of all plant and machinery leased with the land, and
- the market value of non-background plant and machinery does not exceed 5% of the market value of the land (including buildings and fixtures).

Conclusion

The new long lease funding rules have added complexity to the existing leasing legislation and in certain circumstances this will impact on other areas of business, including property. An effort has been made to minimise the impact on property investors however each transaction will need careful consideration to establish whether the new rules apply and there is an increased risk when landlords incur expenditure on a tenant's trade specific fit out works.

If you have any queries regarding this issue please contact Kevin Meyer meyer@capitus.co.uk.