

## Finance Leasing

### Part 04-06-04

This document should be read in conjunction with Chapter 5, Part 4 TCA 1997.

Document last revised June 2018.

A more recent version of this manual is available.

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## 1 Introduction

Section 76D TCA 1997 and section 80A TCA 1997 govern the taxation of income from the trade of finance leasing.

s.76D TCA 1997 provides that the lessor will be taxable on the full lease payments received regardless of the accounting treatment while s.80A TCA 1997 provides an alternative treatment in the case of the leasing of short life assets. s.80A TCA 1997 provides that a lessor may elect to have income from finance leases of short life assets taxed in accordance with accounting principles rather than under the rules set out in s.76D TCA 1997. In such cases, the lessor is taxed on the interest element only of the lease and has no entitlement to claim capital allowances.

[Tax and Duty Manual Part 11-00-01](#) deals with the tax treatment where the leased asset is a passenger motor vehicle. This Tax and Duty Manual sets out the tax treatment applicable to finance leases of other assets used for the purposes of a trade or profession where the lessor has not made an election to be taxed in accordance with s.80A TCA 1997.

### 1.1 Finance Leases

A finance lease is a lease that transfers substantially all the risks and rewards of ownership of an asset to the lessee. Most finance leases operate for a primary period during which the lessee effectively pays for the asset and for a secondary period during which the lessee may continue to lease the asset for a nominal amount.

Payment under a finance lease may be in the form of recurring payments or initial leasing charges (i.e. a lump sum payable at commencement of the lease, which may represent a trade in of another asset against the leased asset). Various other types of payment may arise in more complex leases including lump sum payments made by the lessee at the end of the lease-term (balloon payments).

## 2 Principles of taxation for finance leases where s.80A TCA 1997 does not apply

### 2.1 General

For tax purposes, profits are calculated and capital allowances are allowed on the basis of the legal form of the transaction. The lessee is allowed a deduction for lease rentals in so far as these have been laid out wholly and exclusively for the purposes of the lessee's trade; the lessor is charged on these rentals in accordance with s.76D TCA 1997 and is entitled to claim capital allowances in respect of the asset.

## 2.2 Tax adjustments required

In accounting for finance leases, the lessee recognises the leased asset in the balance sheet and charges depreciation and finance charges in relation to the asset in the profit and loss account.

In adjusting the profit for tax purposes, the depreciation and finance charges are added back and relief is allowed for lease rentals.

## 2.3 Timing of allowance

In considering the period in which a deduction for lease rentals is allowed, regard must be had to the ordinary principles of commercial accounting. The timing of the deduction is by reference to the accruals concept which provides for the matching of revenues with associated costs.

In practice this operates as follows:

- Ordinary recurring payments under a finance lease should be written off on a straight line basis over the period during which it is expected that the asset will be leased.
- Initial lease rentals under the lease or up-front payments made by the lessee represent a payment, in advance, of lease rentals and are allowed over the period during which it is expected that the asset will be leased.

In practice most finance leases terminate at the end of the primary period.

All leasing charges, including up-front payments should be written off on a straight line basis over the period during which it is expected the asset will be leased.

A judgment will have to be made as to the expected period over which the asset will be leased. Where it is reasonably certain at the inception of the lease that the lessee will exercise the option to lease the asset beyond the primary period, the payments should be written off over the period during which it is expected that the asset will be leased. Otherwise, the payments may be written off over the primary period of the lease.

In practice the primary period should be not less than 3 years. However, where payments are written off over a primary lease period which is shorter than the usual primary lease period for assets of the type in question, taxpayers may be required to satisfy Revenue officials that the treatment adopted is reasonable in the circumstances.

## 2.4 Defeasance payments

In many leasing transactions, the lessee enters into a defeasance agreement with a third party where, in consideration for an upfront payment, the third party agrees to make the rental payments under the lease.

Where this occurs, the defeasance payment may be deducted as an expense provided the amount is written off over the life of the lease.

## 2.5 Rebates of rentals

At termination of the lease, the asset is sold by the leasing company for its market value. The majority of finance leases provide for a rebate of rentals to the lessee on termination. The amount of the rebate is generally equivalent to the market value of the asset less a transaction fee charged by the leasing company. Where the lessee does not wish to acquire the asset, the finance company issues a cheque for the difference between the amount realised on sale less amounts owing to the finance company.

Where the lessee wishes to acquire the leased asset, the leasing company will set the rebate of rentals against the cost to the lessee of the asset (i.e. market value) and the lessee pays any balance owing on the lease to the leasing company.

Where the lessee wishes to trade-in the leased asset against another leased asset, the rebate of rentals is set against the cost of the new asset. Where the new lease is issued by a different finance company, that company generally issues a cheque to the dealer for any amount owing on the old lease.

The dealer passes this cheque to the old finance company. The lease agreement will generally show the up-front payment as an initial payment made under the lease. A balancing allowance or balancing charge arises to the lessor by reference to the difference between the amount realised on disposal (market value) and the written down value of the asset.

The amount of the rebate of rentals, whether paid to the lessee, set against the cost of acquisition by the lessee of the leased asset or set against the cost of a new leased asset, represents a return of leasing charges already allowed for tax purposes to the lessee. It should be included in calculating the trading profits of the lessee for the basis period in which it arises. Since the rebate is a cash receipt (or equivalent, where set against the cost of a new asset) it should be included in calculating trading profit in all cases.

### Example

Market Value of asset at end of lease(i.e. cost to lessee)	€5,000
Net final payment due by lessee to finance company	€500

The lessee should include the market value of the asset as a trading receipt for the period in which the transaction takes place and claim capital allowances by reference to the cost of the asset i.e. €5,000. The lessee is entitled to a deduction for the final

payment to the finance company i.e. the net amount on which the lessee is taxable is €4,500:

Final payment made by lessee (balance owing on lease)	€500
Rebate of rentals i.e. market value of asset	(€5,000)
<i>Net amount to be included in calculating trading profits</i>	<i>(€4,500)</i>

## 2.6 Treatment of trade-ins/up front payments

A trader may wish to finance only part of the cost of an asset by way of finance lease. The balance of the cost is met either by way of:

- An up-front payment made by the lessee to the supplier of the asset
- or
- Trade-in of an existing asset including a leased asset (both are referred to hereafter as up-front payments).

The lease agreement will generally show the up-front payment as an initial payment made under the lease.

For tax purposes, the lessor qualifies for capital allowances on the full cost of the asset.

As indicated above the initial lease payment under the lease or an up-front payment made by the lessee is regarded as an advance payment of leasing charges. The lessee is allowed to write off the payment over the period during which it is expected that the asset will be leased by the lessee. In general, this is taken as the primary period of the lease.

### Example

Leased Asset cost	€25,000
Up-front payment paid by lessee to supplier	€10,000
Total payable to finance company including finance charges	€20,000

Payable under finance lease:

Up-front payment of €10,000 plus €5,000 per annum over 4 years (primary period)

The lessee is allowed the annual amounts payable under the new finance lease plus €2,500 per annum in respect of the up-front payment.

Payable under finance lease	€5,000
Up-front payment spread	€2,500
<i>Total Allowed to lessee/charged on lessor</i>	<i>€7,500</i>

### Note

In practice, lessees frequently seek to deduct the up-front payment in the year in which the lease is taken out i.e. in the above example they claim €15,000 for year 1 (i.e. up-front payment of €10,000 and first annual payment of €5,000) and €5,000 for each subsequent year. **This is incorrect.**

## 2.7 Trade-in of asset on lease

Where the leased asset is traded-in against another leased asset, the market value of the trade-in is in effect a rebate of rentals already paid and should be treated as a trading receipt of the lessee for the period in which the trade-in takes place. This amount will be treated as an up-front payment and dealt with accordingly.

### Example

A leased asset is traded-in for €5,000 against a replacement asset which is leased for a primary leasing period of 4 years @ €7,000 per annum. At the time of the trade-in the leasing company is owed €500 on the leased asset. The lessee should include the amount realised on trade-in (€5,000) as a trading receipt and claim a deduction for this amount over the primary leasing period. The net amount to be claimed by the lessee in year 1 of the new lease is:

Rebate of rentals (net)	(i)	(€4,500)
Leasing charge for new asset		€7,000
Up-front payment (trade in €5000 x 25%)		€1,250
Allowable	(ii)	€8,250
Net amount allowable Year 1 (ii) less (i)		€3,750

## 3 LADCO transactions

Revenue has agreed with the Irish Finance Houses Association certain procedures (known as LAD - leased asset disposal) to be adopted by leasing companies for end of lease transactions. The procedures are acceptable for income tax, corporation tax and VAT purposes.

The transactions involve the use of a special purpose company set up under the auspices of the Irish Finance Houses Association called the Leased Asset Disposal Company (LADCO). The transactions can be summarised as follows:

- The leasing company invoices LADCO for the sale of the asset i.e. the leasing company sells the asset to LADCO. The sale must be at market value
- Where the lessee wishes to acquire the asset, LADCO invoices the lessee for the asset i.e. LADCO sells the asset to the lessee
- The lessor issues a rebate of rentals credit note to the lessee. The rebate usually equates with the bulk of the sale consideration.

To reverse the disposal e.g. where a mistake has been made or at the request of the lessee, the following transactions take place:

- The lessor issues LADCO with a credit note for the asset
- LADCO issues a credit to the lessee for the asset
- The lessor issues a cancelling reversal of rebate invoice to the lessee.

Standard invoicing documentation is used to give effect to these transactions.

## 4 Early Settlements

An early settlement of a lease usually involves payment of a sum by the lessee to the lessor in order to settle the lease early. The sum paid will be an amount which at least adequately compensates the lessor for any cost to him of the early settlement of the lease. The circumstances in which early settlements may occur include emigration or death of a lessee. Where the lessee has sufficient funds, he may wish to settle the lease with a lump sum. The early settlement of a lease should not result in the lessee gaining legal title to the leased asset. (In general, if there is any arrangement whereby the lessee can acquire the asset the lease will be treated as a hire purchase transaction.)

Where there is a genuine change in the intentions of the lessor and the lessee which was not envisaged at the start of the lease Revenue continue to treat the arrangement as a lease rather than a hire purchase transaction.

## 5 Capital Gains Tax

Under s.603 TCA 1997, gains on the disposal of assets which are tangible moveable property and which are wasting assets, are exempt from CGT. The exemption does not extend to the disposal of such assets if, for the period of ownership of the person making the disposal, they are used solely for the purposes of a trade or profession and that person has or could have claimed capital allowances in respect of expenditure attributable to the asset – s.603(2) TCA 1997

As most leased assets are precluded, by virtue of s.603(2) TCA 1997, from the s.603(1) TCA 1997 exemption, a CGT charge can arise on the disposal of such leased assets. A disposal occurs, where at the end of the lease period the asset is sold by the lessor to LADCO. There is a further disposal where the asset is sold either to the lessee or to a third party.

Where the formerly leased asset is acquired by the lessee, the cost of the asset for CGT purposes is the amount for which the asset is sold to the lessee (i.e. market value), before deducting any amount in respect of rebate of rentals. The lease rentals paid by a lessee for the lease of an asset are not payments to acquire ownership of the asset. They are simply payments for the use of the asset.