Leasing of Machinery or Plant – General Principles of Taxation

Part 04-06-04

This document should be read in conjunction with sections 76A, 76D and 603 of the Taxes Consolidation Act 1997

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1 Introduction

A lease is an agreement where one party (the lessee) agrees to pay a specified rent for the use of a specific asset owned by another party (the lessor) for a fixed term.

For accounting purposes, a lease can be a finance lease (being a lease that transfers substantially all the risks and rewards of ownership of an asset to the lessee) or an operating lease (being a lease that does not transfer substantially all the risks and rewards of ownership of an asset to the lessee, or effectively a lease that is not a finance lease).

In law a lease typically remains a rental arrangement and is generally treated as such for tax purposes, unless the transaction has the hallmarks of a financing arrangement (the tax treatment of such leases is set out in section 299 of the Taxes Consolidation Act 1997) or the lease is in respect of a short-life asset (the tax treatment of which is set out in section 80A TCA).

This manual sets out the general tax treatment applicable to leases of machinery or plant, with particular regard to lease arrangements where the burden of wear and tear falls directly on the lessor. Although the contents of this manual applies to income arising from the leasing of cars, capital allowances available for cars and deductibility of car lease payments is set out in Tax and Duty Manual Part 11-00-01.

This manual sets out the general legislative framework[1] applicable to the calculation of the profits and gains related to leases of machinery or plant from 1 January 2024, following the commencement of Finance (No.2) Act 2023. This document reflects current Revenue guidance on matters relating to the taxation of such leases, superseding all previous guidance on the topic.

[1] This manual does not set out the framework for the taxation of:

- leases which are treated as financing transactions for tax purposes (being those where the profits and gains are calculated in accordance with section 299), nor
- leases of short-lived assets (being those whose profits and gains are calculated in accordance with section 80A).

In addition, this manual does not cover the availability of capital allowances on leased assets.

2 Accounting form of Lease Transactions

This chapter considers generally accepted accounting practices in Ireland for tax purposes only i.e. FRS and IFRS standards.

For accounting purposes, a lease can be classified as either a Finance Lease or an Operating Lease.

2.1 Finance Leases

A lease is typically classified as a finance lease for accounting purposes where the lease is considered to have transferred substantially all the risks and rewards incidental to ownership of the leased asset from the lessor to the lessee.

Whether the risks and rewards have transferred such that the lease should be classified as a finance lease for accounting purposes is a judgment made by a suitably qualified accountant based on the substance of the transaction (rather than the legal form of the arrangement).

Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are set out below:

1. The lease transfers ownership of the asset to the lessee by the end of the lease term.
2. The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable meaning that, at the inception of the lease, it is reasonably certain that the option will be exercised.
3. The lease term is for the major part of the economic life of the asset, even if title is not transferred at the inception of the lease.
4. At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.
5. The leased assets are of a specialised nature such that only the lessee can use them without major modifications being made.

Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

- if the lessee can cancel the lease, **and** the lessor’s losses associated with the cancellation are borne by the lessee,
- gains or losses from the fluctuation in the residual value of the leased asset accrue to the lessee (such as a rent rebate equalling most of the sales proceeds at the end of the lease), and
- the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

2.1.1 Accounting Treatment of Finance Leases

In accounting for a finance lease, both the lessor and the lessee will typically treat the transaction substantively as if it was the financed sale of the asset to a lessee (or the provision of finance to the lessee to allow them to purchase the asset) with the accounting profits arising from the transaction computed on that basis.

Although a detailed accounting analysis is beyond the scope of this manual, at a high level, the lessor will derecognise the plant and machinery asset in their balance sheet (even where legal ownership of the asset has been retained by the lessor), and instead recognise their net investment in the lease as an amount receivable - this is roughly the present value of the amounts accruing to the lessor as a result of the lease. The lease rental payments receivable are treated as comprising both a capital repayment and an interest/ finance charge element with:

- the interest/finance charge element being recorded as income in the profit and loss account, and
- the capital element reducing the amount receivable in the balance sheet.

Similarly, the lessee will not treat the finance lease as a simple rental arrangement in their accounts and will instead recognise:

- their right to use the leased asset as an asset on their balance sheet, and
- their obligation to pay future lease rentals as a lease creditor.

The "right of use" asset is depreciated over the shorter of the lease term and the normal useful life of the actual asset[2]. The lease payments made by the lessee will also be treated as comprising a capital and financing charge element with:

- the finance charge element recorded as an expense in the profit and loss account, and
- the capital element reducing the lease creditor payable in the balance sheet.

2.2 Operating Leases

An operating lease for accounting purposes is, quite simply, a lease that has not been classified for accounting purposes as a finance lease.

2.2.1 Accounting Treatment of Operating Leases

How an operating lease is treated for accounting purposes is dependent on the following factors:

- whether the accounts are being prepared by the lessor or the lessee, and
- the accounting standards used to prepare the financial statements.

Although, as noted previously, a detailed accounting analysis is beyond the scope of this manual, at a high level, all operating lessors will treat the transaction as if it were an

[2] However, if the lessee is expected to retain the asset after the lease period, the asset will generally be depreciated over the useful life of the actual asset.

arrangement pertaining to the rental of its own plant and machinery assets (an approach that is more aligned with the typical legal form of the transaction), with the accounting profits arising from the transaction computed on that basis. The lessor will generally:

- record lease income as income in the profit and loss account on a straight-line basis (or some other systematic or rational basis e.g. reducing balance), and
- depreciate the leased asset in accordance with accounting standards.

How an operating lease is accounted for by a lessee is dependent on the accounting standards used to prepare the financial statements.

2.2.1.1 FRS 102 Lessees

An FRS 102 lessee will treat operating lease payments as rental payments for the use of an asset they have no ownership interest in. Lease rentals payable are expensed in the profit and loss account on a straight-line basis over the life of the lease contract (or some other systematic or rational basis).

2.2.1.2 IFRS 16 Lessees

IFRS 16 - Leases was issued in January 2016 and applies to all companies applying IFRS. The new standard also applies to companies applying Irish GAAP if they convert to IFRS/FRS 101 Reduced Disclosure Framework, rather than FRS 102.

Under IFRS 16, there is no distinction between operating and finance leases for lessees. As such, a lessee is required to recognise their right of use over the leased asset on the balance sheet (or statement of financial position) even where all the risks and rewards incidental to ownership of the leased asset have not transferred substantially to the lessee.

This means the lessee will generally recognise:

- their right to use the leased asset as an asset on their balance sheet, and
- their obligation to pay future lease rentals as a lease creditor,

in a manner similar to that for finance lessees set out in Section 2.1.1.

An IFRS16 lessee may opt to account for their lease as a rental agreement instead where:

- the lease term is less than 12 months, and
- the lease is in respect of a low value asset[3].The lease payments made by the lessee will comprise a capital and financing charge element.

[3] What constitutes a low value lease for an entity under IFRS can vary depending on materiality, but it is generally presumed to be leases for assets with a fair value when new of $5,000 USD or less.

2.3 Treatment of ‘variable’ lease payments

Where the amount of a lease payment is dependent on some factor that is not fully known at the outset of the lease, the ‘variable’ amount of the payment may, when crystalised, either be:

- immediately realised in the period in which it crystalises, or
- spread over the remaining lease term,

depending on the nature of the payment, the accounting standards and accounting policies employed by the lessor or lessee. The timing of this realisation under the accounting form of the transaction may not always align with the legal form.

2.4 Observations on Accounting Form

As can be observed from this section, the form of a lease and the nature and timing of payments made thereunder for accounting purposes can deviate substantively from their actual legal form. This is of particular relevance for many lessees as, except where section 299 TCA applies, no deduction is available under section 81 TCA[4] in respect of the following profit and loss amounts:

- notional interest/finance charge,
- depreciation expense, or
- other capital amounts (being amounts where there is an enduring benefit for a number of years).

As, such material adjustments are often required to the accounting figures in order to determine taxable leasing profits or deductible leasing expenses.

[4] For relief to be available for trading expenses under section 81, the expense must have been “money wholly and exclusively laid out or expended for the purposes of the trade or profession.” As such, no relief is available in respect of notional amounts. Furthermore section 81 does not allow relief in respect of capital amounts.

Relief is generally not available in respect of these amounts for any taxpayer unless a specific provision applies (e.g. section 299 in the case of certain lessees only).

3 General Principles of Taxation for Leases of Machinery and Plant

While the accounting rules may look to the substance of a transaction, for tax purposes regard must be had to the legal form of the transaction – in the case of leases, this is generally one of rental.

The tax treatment of a lease is independent from the accounting treatment. The tax treatment set out in this section applies, subject to any rule or law that may:

- amend the timing of deductions (such as may happen in terms of leases of real property taxable under Case V),
- apply a capital tax treatment and/or allow accounting treatment to apply where certain criteria have been met (i.e. scenarios where sections 80A or 299 apply).

3.1 Impact of Section 76A

Section 76A TCA was introduced in Finance Act 2005 and legislated for the long-established case law principles[5] that Case I and Case II profits or gains of a trade or profession carried on by a company are required to be "computed in accordance with generally accepted accounting practice subject to any adjustment **required or authorised by law** in computing such profits or gains for those purposes."

Given the significant levels of deviation that there can be between the accounting and tax treatment of lease transactions, section 76D TCA was introduced in Finance Act 2006 to provide certainty to finance lessors that section 76A did not change the way in which they were taxed.

As there is now an increased number of scenarios in which the accounting form of a lease varies from its legal form, Finance (No.2) Act 2023 amends section 76D to provide clarity on the "adjustment[s] required or authorised by law" in scenarios where accounting and legal forms substantively differ.

3.2 Section 76D

Section 76D, as amended by Finance (No.2) Act 2023, clarifies how leasing scenarios where there is significant deviation between the accounting and legal forms of the lease are to be treated for tax purposes. As such, the section focuses on the following scenarios:

- the taxation of lessors of finance leases, and
- the taxation of lessees generally.

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[5] "..the profits and loss to be made up for the purposes of ascertaining that difference must be framed consistently with the ordinary principles of commercial accounting so far as applicable and in conformity with the rules of the Income Tax Act" Whimster & Co. v IRC (1925).

This principle was reaffirmed in other cases including Odeon Associated Theatres Ltd. v Jones [1971] 48 TC 257 and in the Irish cases of Cronin v Cork & County Property Company Limited [1986] 3 ITR 198 and Carroll Industries plc and PJ Carroll & Co. Ltd v S. O'Culachain [1988] 4 ITR 135.

Section 76D does not set out the adjustments, if any, that an operating lessor must make to its accounting profits.

Section 76D confirms that for finance lessors and both finance and operating lessees, lease payments are to generally be spread evenly over the lease term (effectively on a straight-line basis).

The section defines the following key terms:

> "**Lease term**" takes its meaning from generally accepted accounting standards (IFRS or FRS) and is generally the expected duration of the lease.
>
> "**Lease payments**" refers to the amounts payable under the lease in respect of the leased asset(s). This includes prepayments and bullet payments arising at the end of the lease. This does not extend to all amounts payable under the lease *contract*, which can include non-lease components (such as security costs). This may also include amounts not covered by the lease contract, but which are truly payments under the lease[6].

3.2.1 Changes to the lease

Where there is a modification to a lease this impacts the timing and spread of the lease payments. Set out below is guidance on how particular modifications to a lease should be dealt with:

1. Change in the Lease Term:
   Where during the course of the lease there is a change to the lease term, the balance of the lease payments must be recalculated and spread evenly over the remaining lease term.

2. Change to the lease payments:
   Sometimes certain lease payments only become properly quantifiable on the crystallisation of a certain event. This is because the lease payment is calculated by reference to a certain event happening, or a condition being met, such that it is not quantifiable at the outset of the lease or is a variable amount.

   - The payment (or a portion thereof) is not quantifiable at the outset of the lease: These amounts are typically linked to some future condition being met that prevents the payment from reasonably being estimated in advance.

     Once the condition is met, the amount should be reflected in the period (or periods) in which the condition is met, and immediately recognised/ expensed, or spread where appropriate, depending on the nature of the payment.

[6] Refer to section 4 of Tax and Duty Manual Part 01-00-06 in relation to looking beyond the label put on a transaction, which is subtly different to substance over form.

Examples of payments that may not be quantifiable at the outset of the lease include:

- ‘power by the hour’ contracts - where the amount of the lease payments in a period (or an element thereof) is dependent on the amount the lessee has actually used the asset in the period (with the usage portion recognised/expensed in each period),
- the release of excess maintenance reserves as supplemental lease rental payments (the timing and manner of recognition for tax purposes will be dependent on the facts and circumstances in each case).

- The payment (or a portion thereof) is calculated with reference to a variable factor: Sometimes a lease payment (or a portion thereof) can vary based on factors such as:
  - an index or a rate (e.g., LIBOR or the CPI) or,
  - changes in market rates.

  In these instances, the lease payments should be estimated at the outset based on current rates at that time. As such, total lease payments should be spread evenly based on current estimates. Where the rate changes, this element of the lease payments should be recalculated and spread over the period to which it relates.

3. Rebates of lease rentals to the lessee at the end of the lease:
   A 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. As such, it should be included in calculating the trading profits of the lessee for the basis period in which it arises[7]. Where a rebate is set against other costs, the inflow of a rebate and the subsequent usage of that rebate are two separate flows relating to different transactions. As such, these amounts should not be netted together.

   However, it should be noted that if the lease rebate by the lessor or a person connected with the lessor is certain from the inception of the lease, then it will form part of the lease payments.

   Equally, if there is a residual amount to be paid to the lessor at the end of the lease by the lessee or a person connected with the lessee, and this is certain from the inception of the lease, it will form part of the lease payments. Where such a residual

[7]Under an anti-avoidance measure, if this amount is not payable in the period in which it arises, a deduction cannot be taken until such time as it is paid. The equivalent rule for lessors is that such amounts are taxable when they arise, unless they are paid earlier in which case, they are taxable when they are paid.

amount is not guaranteed, it will become a lease payment when it is known and will be treated as a change in lease payments as set out above.

Currently, the accounting form of operating lessees under FRS 102 does not substantively deviate from the legal form of the transaction. As such, it is less likely that profits per accounts prepared under FRS 102 will require significant adjustment for tax purposes, and, in many cases the deductible lease expense will be the same when computing both accounting profits and taxable profits. However, minor adjustments may still be required.

3.3 Non-Lease Components and other Obligations in Lease Contract

A lease contract may provide for supplementary services in addition to the provision of the leased asset itself under the lease contract. These can include non-leasing service components such as the provision of insurance, maintenance, or security facilities.

The contracts may also include additional payment obligations on either or both parties such as a requirement to make provisions that may not necessarily be in the nature of lease rental (such as provision for future maintenance events on a 'Big Ticket' asset).

Accounting standards generally require payments for non-rental components to be recorded separately from lease rental[8]. Equally, for tax purposes, non-rental amounts typically do not fall to be treated as lease payments under section 76D.

The terms of the lease agreement and associated documentation should be inspected to determine how such components and obligations should be treated for tax purposes and whether they form part of the actual lease rental or in fact relate to a separate service component. The terms under which these components and obligations arise may also be relevant when determining who bears the burden of wear and tear.

3.4 Interest Income Earned by Lessors

Where a lessor places any amounts received on deposit, including amounts received in advance or in respect of maintenance obligations, the question arises whether interest income generated from these payments will be taxable at the Case I trading rate.

Interest income arising from deposits will generally be taxable under Case III,[9] unless the lessor can demonstrate such deposits were integral to their leasing trade[10].

Taxation under Case III generally also applies to other interest income earned by lessors and other members of the leasing group, including scenarios where:

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[8] As a practical expedient, lessees can choose to amalgamate lease and non-lease components in their accounts. This should only be applied where the amounts are small or the non-lease components are immaterial. There is no similar practical expedient for lessors.

[9] In line with the principles established in Nuclear Electric v Bradley [1995] 68 TC 670

[10] Refer to Tax and Duty Manual Part 02-02-07 for guidance on when deposit interest will be accepted as trading income.

- lessors have drawn down financing to acquire an asset but have not yet acquired that asset (and have therefore not yet commenced to trade), and
- situations where intra group loans are made (other than in the course of a trade[11]).

3.5 Defeasance Payments

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

Such payments (the defeasance payment) are generally capital in nature.

3.6 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 (or the lessee's estate or successor in cases of death) has sufficient funds, they 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.

Where both of the following apply:

- there is a genuine change in the intentions of the lessor and the lessee/successor which was not envisaged at the start of the lease, and
- the lessee/successor does not gain title to the leased asset,

Revenue will continue to treat the arrangement as a lease. The settlement payment made will be spread in the hands of the lessor and the lessee/successor over the remaining lease term.

If the payment is not arising as a result of genuine unforeseen circumstances, the payment may be re-characterised as a non-deductible capital payment.

Where the early settlement payment gives rise to any arrangement whereby the lessee can acquire the asset the lease and the tax treatment thereon will be reviewed and may be reassessed if appropriate.

[11] Refer to Tax and Duty Manual Part 02-02-06 for guidance on what constitutes a trade.

4 Case IV Lessors

Where a lessor is not carrying on a trade of leasing, the lessor will be taxable on the profits from the business of leasing machinery or plant under Case IV.

Where a lessor is taxable under Case IV, they shall generally compute their annual profits in accordance with general Case I trading principles and the timings and adjustments set out in this manual. Section 77(3A) TCA confirms that corporate Case IV lessors may deduct their interest expenses, notwithstanding the provisions of section 76(5)(b) TCA, which generally denies the deduction of interest in computing Case IV profits.

Where a corporate Case IV lessor makes a loss to which section 399(1) TCA applies, section 402(4) TCA[12] provides that the losses are to be computed in terms of the company's functional currency. The relief or set-off for any losses so computed is then allowed in terms of the corresponding euro value. The rate of exchange to be used in the conversion is the average exchange rate for the period in which the loss relief is allowed.

Similarly, a corporate Case IV lessor should compute its capital allowances, and any excess capital allowances that are carried forward under section 308 TCA, in its functional currency.

Whether or not a lessor is engaged in a trade of leasing, or whether the profits are taxable under Case IV, is a subjective test, dependent on the facts and circumstances pertaining to each particular case. See Tax and Duty Manual 02-02-06 for further information on the tests required to determine whether an activity is trading or not.

Examples of Case IV Lessors

1: Excess Plant
Manufacturing company currently has an item of machinery and plant that it is not using, due to a slight downturn in its manufacturing trade. It temporarily leases the asset out.

Applying the badges of trade and case law, (as set out in Tax and Duty Manual Part 02-02-06), Manufacturing Company will not be carrying on a trade and will instead be a Case IV lessor.

2: AOEs of ABS Group
A Financing Group is putting together an asset backed securitisation (or ABS) involving the letting of shipping containers (the assets) on operating leases. The ABS will be funded by way of public debt, and each asset will be held in a separate subsidiary company of the ABS (known as an asset owning entities, or AOEs).

In this instance, all of the work involved in acquiring the assets and leasing the assets to various lessees was done prior to the AOEs taking ownership of the assets. The assets are sold while still under the initial lease.

[12] Refer to Tax and Duty Manual Part 12-04-01 for more details on section 402.

Applying the badges of trade and case law to the facts and circumstances of this ABS structure, and due to the absence of any other evidence of the active conduct of a leasing trade, each AOE will not be carrying on a trade and will instead be a Case IV lessor.

3: Leases held by Individual Persons
Lease portfolios held by individual investors (or in partnerships) are likely to be held as personal investments and not in the course of a trade.

Examples of Case I Lessors

1: Excess Plant
Manufacturing company has changed it business plan such that a large number of items of machinery and plant that it owns are no longer required for the purposes of its manufacturing trade. It identifies that it can lease the assets rather than sell them. Manufacturing company negotiates leases for the assets and continues to maintain the leased assets. Manufacturing company acquires replacement and new assets to lease out as part of this new leasing activity.

Applying the badges of trade and case law, it is likely that manufacturing company will be carrying on a separate trade of leasing.

2: Trade of Car Leasing
Leasing company owns and maintains a large fleet of cars which it leases out through a number of offices and online. Leases can be short term holiday hires, or longer term corporate leases. Leasing company's motive is to earn profits from renting out the cars, which have a finite life as a 'rental car' after which leasing company sells them.

Applying the badges of trade and case law, it is likely that leasing company will be carrying on a trade of leasing in respect of its rental activities.

5 Capital Gains Tax

Items of plant and machinery are generally assets that are **both**:

- tangible moveable property, and
- wasting assets (a term which largely refers to assets with a useful life of <50 years).

Under section 603 TCA, gains on the disposal of assets which are both tangible moveable property and wasting assets, are generally exempt from CGT (often referred to as the wasting chattel exemption).

However, section 603(2) provides that the exemption on disposal of a wasting chattel asset does not apply to a taxpayer where:

- the asset has been used solely for the purpose of a trade or profession during the entire period of ownership, and
- the taxpayer has claimed or could have claimed[13] capital allowances in respect of the expenditure incurred in acquiring the asset.

Where such an asset was only used partly for the purposes of the trade, any exemption available is proportionately reduced relative to the period the asset was used for a trading purpose.

The wasting chattel exemption also does not apply to the disposal of non-trading wasting chattel assets (such as the disposal of formerly leased assets by Case IV lessors) on which capital allowances can be claimed.

As such, most items of leased items of plant and machinery are precluded from the wasting chattel exemption and a charge to CGT can arise on the disposal of such leased assets where a chargeable gain arises.

Where an asset that was previously leased out is appropriated and sold as trading stock, the provisions relating to appropriations to stock in trade set out in section 596 TCA may apply in scenarios where a bona fide appropriation has taken place.

Where an asset that was previously leased out is acquired by the lessee, the cost of the asset for CGT purposes (where the asset is employed as capital) 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 as such amounts do not relate to the acquisition of the asset.

[13] Finance (No.2) Act 2023 requires that regard must also be had to any capital allowances forgone by a lessor by reason of entering into a section 299 lease.