Leasing Ringfences – Sections 403 and 404 TCA 1997

Part 12-04-02

This document should be read in conjunction with sections 403 and 404 of the Taxes Consolidation Act 1997 (TCA)

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Introduction

This manual is a guide to the leasing ringfences in sections 403 and 404 of the Taxes Consolidation Act 1997.

The ringfences aim to prevent the creation of tax advantages using leasing structures by restricting how excess capital allowances arising from leased machinery and plant may be used by a leasing company or group as the case may be.

- *Section 403* places a ringfence around the leasing of machinery or plant generally such that capital allowances on leased machinery or plant can be set off only against leasing income, or amounts arising from "lease-adjacent" activities and not against any other income or gains of the company or wider group. Part A of this TDM covers the section 403 ringfence.
- *Section 404* places additional restrictions on "balloon leases." These are leases that are structured to give rise to accelerated allowances while deferring the taxation of lease receipts to the end of the lease. This ringfence may also apply to certain restructuring and sale and leaseback arrangements. Part B of this TDM covers the section 404 ringfence.

As both ringfences relate to leased machinery and plant and compute restricted amounts using similar principles, they have been included in one Tax and Duty Manual. However, these ringfences:

- are independent of one another,
- apply to different types of leases, and
- have different rules regarding the usage of restricted allowances.

NB The section 404 ringfence provisions (Part B) apply in priority to section 403 provisions. As such, consideration should be given to whether Part B applies to a lease irrespective of its section 403 status.

Part A – Section 403 Ringfence

1 Introduction

Section 403 TCA 1997 was introduced by section 40 of Finance Act 1984.

The section places a ringfence around the leasing of machinery or plant so that, where leasing activities are carried on in conjunction with other activities (such as a banking business), the capital allowances on leased machinery or plant (referred to as "specified capital allowances" in this section[1]) can be set off only against leasing income, or amounts arising from "lease-adjacent" activities and not against any other income or gains.

The ring fence applies to both trading and non-trading lessors.

[1] The allowances affected are broadly those capital allowances arising in respect of machinery or plant provided for leasing on or after 25 January 1984.

2 Trading Lessors

A *'trade of leasing'* is defined in the section as:

(i) a trade which consists wholly of the leasing of machinery or plant, or
(ii) any part of a trade treated as a separate trade by virtue of subsection (2).[2]

Subsection (2) states:

Where in any chargeable period or its basis period a person carries on as part of a trade any leasing of machinery or plant, ***that leasing shall be treated for the purposes of the Tax Acts****, other than any provision of those Acts relating to the commencement or cessation of a trade,* ***as a separate trade*** *distinct from all other activities carried on by such person as part of the trade, and any necessary apportionment shall be made of receipts or expenses.*

Effectively, this section, provides where a company, or an individual, carries on:

- The leasing of machinery or plant under Case I, or
- Case I/II activities which include the leasing of machinery or plant,

those leasing activities are a separate trade for Case I/II purposes.

Profits arising from this separate trade should be assessed separately to other activities carried out by that company or individual.

Receipts and expenses should be apportioned to accommodate this as necessary.

2.1 Other Activities by Leasing Companies

Where a company is carrying on a dedicated leasing business, subsection (2) can give rise to scenarios where activities that are adjacent or related to the leasing activity end up siloed into a separate trade notwithstanding the fact the activities are carried on within the one entity.

To address this, subsection (2A) (as inserted by Finance (No.2) Act 2023), provides that lease-adjacent activities (refer to section 3.2.2.1 for more details) incurred by a company may also form part of the leasing trade in scenarios where both the leasing and adjacent activities would have formed a single trade, but for the existence of subsection (2) (i.e. the adjacent activities would have been treated as trading activities in the same trade had subsection (2) not applied).

Nothing in section 403 deems the lease adjacent activities of a lessor to be trading, if those activities are not trading under first principles.

[2] With section 403(1)(b) clarifying that the letting on charter a ship or aircraft, or the letting of plant or machinery on hire, are to be regarded as the leasing of plant and machinery if they would not otherwise be so.

2.2 Non-Corporate Lessors

Provisions for non-corporate trading lessors are set out in subsection (3).

Generally, under sections 381[3] and 392, capital allowances for a year of assessment (where they exceed the profits or gains of the trade against which they are claimed) may be:

- treated as trading losses and
- relieved against any profits or gains of the year of assessment,

thus, the surplus capital allowances of a trade of leasing are effectively set off (apart from this section) against any other profits or gains of the year for which the allowances are due.

Subsection (3) restricts the loss relief that is available under section 381. It provides that a loss sustained in a trade of leasing by a non-corporate trader cannot, to the extent that it is attributable to specified capital allowances, be set off against any profits other than those from the trade of leasing. In effect, a ring-fence is constructed for tax purposes around the leasing trade and the use of specified capital allowances is confined within that ring-fence.

The section provides that a loss sustained in a trade of leasing, in so far as it is attributable to such leasing capital allowances, is for the purposes of subsections (1) and (3)(b) of section 381 treated as reducing profits or gains of the trade of leasing only.

Example

An individual carrying on a trade of leasing has the following income and capital allowances for the year 2024 for the purposes of income tax:

Lease Rentals Less Expenses	€5,000
Specified 403 (Leasing) Capital Allowances on Leased Machinery	€15,000
Excess Leasing Allowances	*€10,000*
Investment Income	€10,000

If this section did not apply, the excess of capital allowances over lease rentals of €10,000 could be claimed as a loss against the investment income of €10,000, reducing taxable income for the year 2024 to NIL.

By virtue of section 403(3)(a), the excess allowances may not be set off against any other income of the year 2024. Instead, the surplus is available for set-off only against leasing income for the year 2025 and subsequent years.

[3] Refer to TDM Part 12-01-02 for more details on income tax loss relief provisions.

2.2.1 Balancing Allowances

Under section 393 capital allowances must be used to cover a balancing charge before being used to create or increase a loss. Only the amount of capital allowances in excess of such a balancing charge can be used for the purposes of a loss relief claim under section 381.

In the case of specified capital allowances in respect of a trade of leasing, section 403(3)(b) provides that such allowances are to be offset against any such balancing charge in respect of that trade. This allows the maximum amount of non-specified allowances to be used for a loss relief claim against non-leasing income.

Example

An individual carrying on a trade of leasing has the following capital allowances and balancing charges for the year 2024 for the purposes of income tax:

Balancing Charge on Leased Machinery Disposed		€6,000
Capital allowances on leased machinery		
Specified 403 capital allowances	€9,000	
Other (not specified) Capital allowances	€3,000	
Excess of Allowances Over Balancing Charge		€6,000

There is a surplus of €6,000 of capital allowances over balancing charges. This surplus is available for set-off against other income except to the extent that it includes specified capital allowances.

By virtue of subsection (3)(b)(i), €6,000 of the specified allowances of €9,000 is treated as set off against the balancing charge of €6,000 as this relates to a trade of leasing.

Therefore, the excess of allowances over charges of €6,000 is regarded as including €3,000 of the specified allowances and that surplus is reduced to €3,000 for the purpose of a loss relief claim against non-leasing income.

The "other" (not "specified") allowances of €3,000 can be used, to the maximum extent possible, by way of a loss relief claim against other income.

2.2.2 Order of Relief

Where a loss claim is affected by section 403, a degree of flexibility is available with regard to the order in which losses and capital allowances may be relieved against leasing and non-leasing income under sections 381 and 392[4].

[4] Refer to TDM Part 15-02a-06 for more details on the general order of offset rules which apply to

Section 403(3)(b)(ii) provides that a claimant of loss relief under section 381 may specify the extent to which the relief is to be attributed to:

1. actual lease trading losses (being an excess of lease expenditure over lease income),
2. specified capital allowances, and
3. other capital allowances.

The ability to specify how the set-off of a section 381 loss relief claim (that includes a section 392 claim) is to be made is without prejudice to the general principle that specified capital allowances can only be used to reduce profits from a leasing trade. It does, however, enable the taxpayer to have any actual loss from the leasing trade and any other capital allowances deducted first from the non-leasing income.

Example
A (trading) lessor, Tim, has incurred the following losses and received the following capital allowances in 2024 in respect of his lease trade:

Case I Loss	€5,000
Capital Allowances	
Specified Capital Allowances	€5,500
Other Capital Allowances	€4,500

Tim also earned Schedule E employment income of €15,000 in 2024 and intends to make a section 381 claim to reduce his taxable income in the period. Tim wishes to opt to augment his section 381 by way of section 392 where possible.

Tim specifies that his Schedule D Case I loss (before capital allowances) and the non-specified leasing capital allowances are to be treated as reducing his non-leasing income. Tim's total income for 2024 is now as follows:

Schedule E:		€15,000
Less 381 Claim:		
Case I Loss	€5,000	
Other Capital Allowances	€4,500	(€9,500)
Total Taxable Income 2024		€5,500

Specified Capital Allowances of €5,500 are available for set off against leasing income only in future periods.

2.3 Corporate Lessors

Subsection (4) provides for restrictions on the offset of capital allowances on plant and machinery treated as a trading expense of a trade of leasing.

reliefs, deductions and allowances.

In the ordinary course of events, where a company is in receipt of capital allowances in respect of a trade such allowances are treated as expenses incurred in the course of the trade. This reduces the profits of the trade or creates/increases the losses of the trade.

Where a trading loss arises by virtue of that section, the relevant trading loss rules would then apply accordingly.

Subsection (4) of section 403 restricts the amount of loss relief and group relief available where specified capital allowances relating to leased plant and machinery create, or augment, a loss in a company's trade of leasing.

Where relief would otherwise be available under those sections, the ringfence provides that the relevant amount of the trading loss relating to those capital allowances is only available for offset against income and profits from the company's "leasing business" (refer to section 2.3.2.2 for more detail).

2.3.1 Relevant Amount of the Loss

The relevant amount of the loss is the amount of the loss incurred by a leasing company that is "ringfenced" by reason of section 403 i.e. the amount of the loss that is derived from specified capital allowances and subject to restriction.

The relevant amount of the loss is the full amount of the loss where:

- there is no actual lease trading loss (before capital allowances), and
- there are no capital allowances in the company other than specified capital allowances.

In such cases some part of the specified capital allowances has effectively been set off against lease trading profit and created a loss comprised solely of excess specified capital allowances.

In other circumstances, an amount less than the whole of the tax loss will be ringfenced. For example, in scenarios where:

- there is an actual lease trading loss, and
    - no capital allowances other than the specified capital allowances are taken into account in arriving at the tax loss, and
    - the amount of the tax loss is greater than the total amount of the specified capital allowances,

the relevant amount of the loss is limited to the amount of the specified capital allowances only.

Where a company claims both specified and non-specified capital allowances the "relevant amount of the loss" i.e. the ringfenced amount is the lesser of:

- the amount of the specified capital allowances (if that amount is less than the total tax loss), and
- the amount by which the total tax loss exceeds the amount of the "other" capital allowances.

Where the tax loss does not exceed the amount of the capital allowances which are not to be restricted (that is, capital allowances other than the specified capital allowances) no restriction is to be made – effectively it is assumed that the specified allowances would be used to shelter leasing income in advance of other allowances.

How to calculate the relevant amount of the loss is illustrated in the scenarios in Appendix A.

2.3.2 How Ringfenced Losses of Leasing Companies can be used

Similar to individual lessors, ringfenced losses incurred by leasing companies in the course of a trade can be to reduce the income of their leasing trade. However leasing companies can also use such losses to relieve many of the types of income or profits typically generated by corporate lessors (referred to as "lease-adjacent" activities which are covered in more detail in section 2.3.2.1), subject to certain criteria being met.

This means that while the leasing activities may be treated as arising under a separate trade[5], the ringfenced loss may be offset income and/or profits of:

- the company's "leasing business",
- the leasing business of the "leasing business group" (in addition to ordinary lease rental profits of the loss group),

subject to certain criteria being met. The meaning of "leasing business" and "leasing business group" in this context are set out in sections 2.3.2.2 and 2.3.2.3.

The "relevant amount of the loss" (i.e. the ringfenced loss) can be used to reduce the income and profits of the leasing business and leasing business group respectively using the normal loss relief rules. The ringfence restricts the use of these losses for any other purpose i.e. for other unrelated profits of the corporate group. – further detail on how ringfenced losses can be used by corporate lessors is set out in section 2.3.3.

2.3.2.1 Lease-Adjacent Activities

Lease-adjacent Activities are activities that corporate lessors typically undertake in addition to their ordinary lease rental activities. These are specified in clauses (II) to (V) of subsection (1)(d)(ii) and are listed below:

- Clause (II): the provision of finance and guarantees to fund the type of assets that are leased by the leasing business group;

[5] Including, as set out in section 2.1, lease-adjacent activities in certain circumstances.

- Clause (IIA): the provision of finance to an intermediary member of the leasing business group who carries on financing activities referred to in Clause (II) where:
    - the Clause (II) activity is provided to a company carrying out lease rental activity within the meaning of Clause (I),
    - the finance provided to the intermediary member by the company was sourced from an unconnected third party source, and
    - the finance provided is repaid on disposal of the leased machinery or plant;
- Clause (III): the provision of leasing expertise relating to the type(s) of machinery or plant leased by the leasing business group[6];
- Clause (IV): the disposal of machinery or plant acquired in the course of its leasing trade;
- Clause (IVA): the disposal of the right to acquire machinery or plant (or an interest in same) similar to that leased by the leasing business group which was intended to be used by that group for lease rental purposes;
- Clause (IVB): the disposal of any part of an item machinery or plant by the company that was previously used by that company for lease rental purposes (i.e. parting out activities);
- Clause (V): activities ancillary to lease rental, as well as the other lease-adjacent activities listed above.

Example

LeaseCo is headquartered in Ireland and has a number of subsidiary entities carrying on leasing activities and/or lease-adjacent activities. The leasing business group has a range of employees with finance, commercial, technical expertise to acquire, finance and lease their own assets.

LeaseCo has been approached by third party investors to assist with the setting up a new leasing structure. The investors are seeking to lease the same assets as LeaseCo and want to leverage on the expertise built up internally within LeaseCo as the investors lack this experience.

LeaseCo provides consultancy services to the investors relating to the acquisition of assets, identifying potential lessees and is paid an arrangement/ transaction/ consultancy fee for assisting setting up the structure.

As LeaseCo has provided the following expertise to the investors:

- leasing expertise relating to the type(s) of machinery or plant leased by

[6] Where such expertise is provided in conjunction with expertise relating to lease-adjacent activities also carried out by that leasing business group, all such expertise will qualify as a Clause (III) activity.

LeaseCo and its leasing business group (re acquisition and customer identification), **in conjunction with**

- expertise relating to lease-adjacent activities (Clause II and IIA activities) that are also carried out by LeaseCo's leasing business group,

the arrangement/transaction/consultancy fees will be treated as Clause (III) lease-adjacent activities in full i.e. LeaseCo can provide expertise with regard to leasing and other lease-adjacent activities its leasing business group has demonstrable expertise in.

If LeaseCo either:

- provides expertise in relation to lease-adjacent activities other than in conjunction with actual leasing advice, or
- provides expertise in relation to lease-adjacent activities not carried out by its leasing business group (i.e. activities the leasing business group does not have demonstrable expertise in),

any such fees pertaining to the provision of this expertise will not be treated as a Clause (III) lease-adjacent activity.

2.3.2.2 Meaning of "Leasing Business"

A company's will be carrying on a leasing business where **both** tests below are met.

Test 1: Does the company (and its wider group) have activities that consist wholly or mainly of leasing?

For these provisions to apply to a company, the activities of either:

(I) the company itself,
(II) the company and all companies
  - of which it is a 75 per cent subsidiary, and
  - which are its 75 per cent subsidiaries[7], or

(III) the company and all companies
  - of which it is a 75 per cent subsidiary, and
  - which are its 75 per cent subsidiaries,

who are resident in the same territory as that company,[8] or

(IV) the company and its corporate group for group relief purposes (being a group within the meaning of section 411(1),

must consist wholly or mainly of the leasing of machinery or plant i.e. the actual lease rental must make up more than 50% of the activities of either the company or other grouping selected.

[7] In this test and in the test in (III) it should be noted that the relationship must be vertical (parent / sub) rather than horizontal (sister subsidiaries).

[8] There is a high degree of similarity between the tests in (II) and (III), with-

- (II) allowing the company to have regard to its worldwide group, while
- (III) allows the company to look only at the operations carried on in Ireland.

And

Test 2: Are 90% or more of the activities of the company's business related to leasing activity or activities adjacent to leasing?

The activities of the company must be not less than 90% of a combination of the following:

(a) the leasing of machinery or plant, and/or
(b) a lease-adjacent activity or activities.

Where a company passes these 2 tests, it (alongside the other companies in its grouping if Clauses (II)-(IV) are selected shall be considered to be carrying on a leasing business for the purposes of section 403.

In determining whether a company is carrying on a leasing business and whether Test 1 and/or Test 2 have been met, activities explicitly excluded from the ringfence (being certain chartered shipping activities[9] and activities within the meaning of section 80A(2)(c)) are to be disregarded.

2.3.2.3 Leasing Business Group

For the purposes of section 403 a company forms a leasing business group with those entities relevant to determining its status as a leasing business.

A leasing rental company (i.e. a company that can pass both Tests 1 and 2 in its own right) can form a leasing business group with any companies that, when considered along with the leasing company, pass Test 1 and Test 2.

2.3.3 Use of "Relevant Amount of the Loss" (i.e. the Ringfenced Loss)

This section sets out how the "relevant amount of the loss" incurred by a leasing company may be used by that company and its wider corporate group (being its corporate loss group for the purposes of section 411(1)).

Where a company incurs a "relevant leasing loss" the "relevant amount of the loss" is only available for relief under:

- ***section 396A*** (*relief for relevant trading losses*) insofar as it can be used to reduce the income of the company's leasing business,
- ***section 396B*** (*relief for certain trading losses on a value basis*) insofar as it can be used to reduce the corporation tax chargeable on the profits of the company's leasing business,

[9] Refer to section 403(1)(b), section 403(1)(c) and section 407(4)(c)

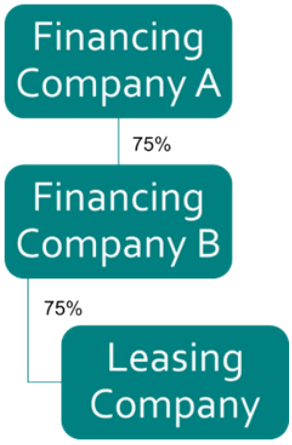
- ***section 420A*** (*group relief: relevant losses and charges*) insofar as it can provide group relief for either:
    - trading lease rental income in the group, or
    - trading income of the leasing business of a member of the company's leasing business group, or

- ***section 420B*** (*group relief: relief for certain trading losses on a value basis*) insofar as it can be used to provide group relief to reduce the corporation tax chargeable on the profits of the leasing business of a member of the company's leasing business group.

In a case where a leasing entity intends to surrender the relevant amount of the loss by way of group relief, it should be noted that the company whom the losses are being surrendered to must be part of the company's corporate loss group (i.e. a company with which the leasing company can form a group within the meaning of section 411(1).)

For example, 100% of Leasing Company's activities relate to leasing machinery or plant.

- Leasing Company's status as a leasing company was relevant to Financing Company A and B's status as part of a Leasing Business for the purposes of section 403.
- Leasing Company incurs a relevant leasing loss, and it may surrender the relevant amount of that loss to Financing Company B by way of group relief[10] allowing Financing Company B to reduce its leasing business profits.
- Leasing Company cannot surrender such amounts to Financing Company A as they are not in the same group for the purposes of section 411(1).



[10] Subject to the conditions for section 420A or 420B being met.

3 Non-Trading Lessors – Case IV

Subsection (5) deals with the tax treatment of the excess capital allowances arising from Case IV leases.

Where a taxpayer carries on activities that are taxed under Case IV and claims capital allowances in respect of those activities, sections 305 (individuals) and 308 (corporate taxpayers) normally allow any excess capital allowances to be offset against the current year profits or the prior year profits before being available for carry forward.

The amount carried forward can only be used against "income of that specified class" being similar income in subject to the same case. In the case of lessors of plant and machinery, this refers to any Case IV lease income.

Subsection (5) restricts the relief which would otherwise be available under section 305(1)(b) for individuals or sections 308(4) or 420(2) for corporates.

3.1 Non-Corporate Lessors

Subsection (5) provides that where an individual has excess Case IV capital allowances in a period, such allowances:

- may only be carried forward for use against future Case IV leasing profits, and
- cannot be offset against current or prior year profits (whether or not such profits related to leasing profits taxable under another Case).

3.2 Corporate Lessors

Where a corporate lessor has excess specified capital allowances arising from non-trading leasing activities, subsection (5) provides that relief is available:

- against future Case IV leasing profits,
- against other leasing business profits in that company (such as chargeable gains),
- by way of group relief against:
    - other lease rental profits arising in the corporate group, or
    - the profits of the leasing business of a member of the company's leasing business group[11].

[11] Similar to the example in section 2.3.3, this company must also be a member of the Company's corporate loss group for the purposes of section 411(1).

Part B – Section 404 Ringfence

4 Introduction

Notwithstanding section 403, leases of machinery and plant were being structured in a manner designed to allow accelerated allowances in the early stages of a lease while postponing the taxation of lease receipts until the end of the lease. The result was that the lessor was able to use the accelerated capital allowances to shelter taxable income arising from other leasing activities. These are often referred to as "balloon leases."

Section 404 therefore requires taxpayers to treat:

- each relevant lease entered into, in the case of non-corporate lessors, and
- all relevant leases entered into, in the case of corporate lessors,

in the course of a trade, as a separate standalone lease trade[12] (known as a "specified leasing trade" in the case of non-corporate lessors or a "balloon leasing trade" in the case of corporate lessors). This specified leasing trade or balloon leasing trade is then treated as distinct from all other activities - including other leasing activities - of the taxpayer.

Section 404 then requires the taxpayer to apply the ringfence rules of subsections (1), (2), (3) and (4) of section 403[13] to the relevant lease as if all references to a "trade of leasing"[14] in those subsections were to that "specified leasing trade" or "balloon leasing trade", as the case may be.

This has the effect of putting the activities of the relevant lease (or leases in the case of corporate lessors) into a completely separate ringfence to all other leasing activities, allowing excess capital allowances arising from the leased asset to only be available for offset against:

- income of that relevant lease, in the case of non-corporate lessors,
- income from that relevant lease and all other relevant leases in the same company, in the case of corporate lessors.

Whether a lease is a relevant lease or not is (subject to certain exceptions) determined by formulae which examine whether:

- the spread of lease payments is broadly even over the lease term, and
- the balance of payments due is to be paid immediately[15] after the end of the lease period.

[12] Other than any provision of those Acts relating to the commencement or cessation of a trade
[13] Note that this does not include subsection (2A) meaning that lease adjacent activities cannot form part of a trade to which section 404 applies.
[14] The phrase "trade of leasing" is not used in section 403(2). The separate standalone trade is created by section 404(2), not by modifying section 403(2).
[15] Other than an inconsequential amount

Where a lessor generally records their lease rental income for tax purposes evenly over the life of the lease, the lease is an "even lease" and the section 404 ringfence will not apply[16].

A lease could also be deemed to be a relevant lease in the case of certain restructuring and sale and leaseback arrangements.

4.1 Key Terms

even lease refers to any lease whose income is recognised evenly for tax purposes[17] over the lease term (i.e. the income is recognised on a straight-line basis). Where there is a change in either:

- the lease term, or
- the lease payments (e.g. in a 'power by the hour' scenario),

a lease will continue to be an even lease where the adjustments made on foot of these changes are consistent with the changes that would be required if the lease was a lease to which section 76D applies. The nature of the changes required is set out in further detail in Paragraphs 1 and 2 of Section 3.2.1 of Tax and Duty Manual Part 04-06-04.

fair value (of a leased asset) is

- the price of the asset at an arm's length basis at the inception of the lease, *less*
- any grants receivable by the lessor towards the purchase of the asset.

inception of the lease is the earlier of:

- the date on which the asset is brought into use, or
- the date from which lease payments first accrue.

lease payments are the payments made to the lessor in respect of the leased asset. This includes any residual amount to be paid to the lessor on or after the lease term that is guaranteed by the lessee or a person connected with the lessee. If the residual payment is guaranteed by an unconnected third party, the payment is only considered a lease payment where the guarantee is part of an arrangement between the lessee and the third party.

predictable useful life is the useful life of the asset as estimated at the inception of the lease. The estimate is based on the assumption that the asset will be used as intended and its life will end when it can no longer be used as intended.

relevant lease payment is the amount of a lease payment to be made under the terms of the lease.

[16] Section 403 will continue to apply to even leases in the ordinary manner.
[17] This is regardless of how the lease may be treated for accounting or for other legal purposes.

In certain cases, it may not be possible to determine the amount of a lease payment as it will be variable in nature. In such cases the lease may instead provide that the lease payments are to be determined by reference to a rate [18].

In such cases, the relevant lease payments should then be calculated as if the particular rate which applies at the inception of the lease does not change. This will enable a lessor to determine, at the inception of the lease, whether a lease falls foul of the section.

"relevant lease payments related to a chargeable period or its basis period" is the relevant lease payments which are:

- received in the period concerned, and
- taxable in that period or an earlier period.

Where it is not possible to determine the lease payments (as set out under the definition of a relevant lease payment), the test as to whether payments are taxable is applied as if the anticipated payments were the actual payments to be made.

"relevant period" is the period beginning at the inception of the lease and ending:

- when the lessor has recovered 90% of the investment in the asset[19], or
- the end of the predictable useful life of the asset, if sooner.

However, if the relevant period is determined to be more than 7 years, the relevant period is to be recalculated on the basis of a 95% test instead of a 90% test.

[18] Note that the rate should be an internationally recognised reference rate.

[19] 90% of the investment has been recovered at the point where if the present value of the relevant lease payments payable was calculated, it would equal 90% of the fair value of the leased asset.

5 Relevant Leases

The section applies to "relevant leases" only. These are lease structures with uneven leasing profiles for tax purposes (sometimes referred to as "balloon leases").

As a general rule, a lease, other than an even lease, is a relevant lease unless the actual lease payments are spread evenly[20] throughout the primary lease period.

For example, in a 10-year lease with an even lease profile, one would expect to see—

- 10% of the total lease payments received and taxed by the end of year 1,
- 20% of total lease payments received and taxed by the end of year 2,

and so on.

5.1 Tests to determine if a lease is a relevant lease or not

For section 404, a lease, other than an even lease, is generally deemed to be a relevant lease unless **both** the 'Formula Test' and 'Balance of Payments Test' (which are set out below) are passed.

Section 404(1)(b)(v) provides that a lease is not a relevant lease if it is one only by reason of exchange rate differences.

5.1.1 Formula Test [Section 404(1)(b)(i)(I)]

For any chargeable/accounting period of the lessor which forms part of the relevant period, the aggregate of the relevant lease payments related to:

- that period, and
- any earlier period,

is greater than or equal to the amount determined by the formula:

$$\underbrace{(W \times P)}_{\text{First Part}} \times \underbrace{\left(\frac{90+(10\times W)}{100}\right)}_{\text{Second Part}}$$

The First Part of the formula tests whether or not the lease profile is even:

W = is the proportion of the primary lease period which has expired. This is calculated by dividing

- the period which has expired (E), by
- the length of the relevant period (R)

P = Total Lease Payments due under the Contract

[20] This test is based on the actual timing of the payments under the lease and not the timing for tax purposes.

The Second Part of the formula incorporates some flexibility into the overall calculation. A lease is not a relevant lease where the aggregate of the relevant lease payments is broadly even. This means in any year the aggregate payments must be between 90% and 100% of the amount in the First Part of the formula.

The percentage will move from 90% to 100% over the course of the relevant period.

For example, in a 10-year lease, a lease shall not be a relevant lease where the aggregate of the relevant lease payments is:

- 91% of the amount calculated in the First Part in year 1,
- 92% in year 2,
- 93% in year 3,

and so on.

5.1.2 Balance of Payments Test [section 404(1)(b)(i)(II)]

Any balance of payments due under the lease (other than an inconsequential amount) must be paid immediately after the end of the relevant period.

- In the case of a lease with a relevant period $\leq$7 years, the balance must be paid within
  - $\frac{1}{7}$ of the length of the relevant period, or
  - 1 year if that is greater.

- In the case of any other lease, the balance must be paid within
  - $\frac{1}{9}$ of the length of the relevant period, or
  - 1 year if that is greater.

5.2 Exclusion for Short-Life Assets

Section 404(6)(a)(ii) provides that leases meeting the following criteria are not relevant leases:

- the relevant period does not exceed 5 years
- the predictable useful life of the leased asset does not exceed 8 years
- apart from the first accounting period, the aggregate of the amounts of lease payments payable under the lease before the end of the current chargeable period is not less than an amount determined by the formula[21]

[21] Which tests to see if the lease payments generally equate to annual payments of approx. one eighth of the original value of the asset.

$$\frac{V \times T}{2920}$$

where:

V is an amount equal to the fair value of the asset at the inception of the lease, and

T is the number of days in the period commencing at the inception of the lease and ending at the end of the current chargeable period,

and

- the lessor has elected to have capital allowances on machinery and plant proportionately reduced on a time basis in periods where the machinery or plant is used for part of a chargeable period only.

6 Application of Section 404 Ringfence to Corporate Lessors – "Balloon Leasing Trades"

Subsection 404(2B) requires corporate lessors to amalgamate their "specified leasing trades" into a single "balloon leasing trade," which is segregated from any other trade of leasing in the company.

A corporate lessor is not allowed incorporate any activities adjacent or related to the leasing activity into their balloon leasing trade.

6.1 Use of Relevant Leasing Losses in Balloon Leasing Trades

The company may offset relevant leasing losses derived from balloon leases against other income in its balloon leasing trade only (i.e. Case I/II balloon leasing income in that company only) by way of section 396A and 396(1). Group relief (sections 420A and 420B) and value basis relief (section 396B) are not available for relevant leasing losses from balloon leasing trades.

6.2 Surrender of Relevant Leasing Losses and Excess Capital Allowances to Balloon Leasing Trades

Although a balloon leasing trade cannot surrender losses to other income or profits of the company, or the wider "leasing business" of the company or "leasing business group",[22] a balloon leasing company can form part of a "leasing business" or "leasing business group" and relevant leasing losses or excess capital allowances to which section 403 applies from either the business, or business group, as the case may be, may be used to offset income from a balloon leasing trade subject to the ordinary qualifying criteria being met[23].

[22] Refer to the meaning of "leasing business" and "leasing business group" in this context are set out in section 2.3.2.2 and section 2.3.2.3 of Part A of this manual.
[23] Refer to section 2.3.3 of Part A of this manual for further detail on how relevant leasing losses may be used under section 403.

7 Agricultural Machinery

The section 404 ringfence is modified, by subsection (3), in the case of agricultural machinery to take into account the effect of seasonal factors on the timing of lease payments.

For the purposes of this section, agricultural machinery is machinery or plant which is used (or intended to be used) for the purposes of:

- a farming trade, or
- a trade carried on by an agricultural contractor.

The modification adjusts a relevant lease payment under such a lease from:

- the actual relevant lease payment, to
- the average of the current year and prior year relevant lease payments.

8 Sale and Leaseback Arrangements

Subsection (5) contains an anti-avoidance provision for sale and leaseback arrangements. This section targets arrangements where:

1. a person who owned an asset sells the asset, and
2. that person (or a connected person) takes the asset on lease from the person to whom it was sold (or a connected person).

Subsection (5) provides that leases of machinery or plant arising out of a sale and leaseback arrangement shall **always** be subject to the section 404 restriction unless:

1. The machinery or plant is new, or
2. There is a pure even spread of lease payments over the lease term - This is equivalent to the result of the formula test (in section 2.1.1) if the "second part" was disregarded. This means for any chargeable/accounting period of the lessor which forms part of the relevant period, the aggregate of the relevant lease payments related to:

   - that period, and
   - any earlier period

   is greater than or equal to the amount determined by the formula:

   $$(W \times P)$$

   Where:

   W = is the proportion of the primary lease period which has expired. This is calculated by dividing

   - the period which has expired (E), by
   - the length of the relevant period (R)

   P = Total Lease Payments due under the Contract

9 Restructured Leases

Subsection (4) seeks to ensure that leases that are restructured for section 404 tax planning purposes shall be relevant leases.

Subject to subsection (4A) (as set out in section 6.1), a restructuring that results in a higher level of payments being payable, as compared with the level which would have otherwise been payable shall cause the lease concerned to be treated as a relevant lease unless the restructuring is carried out for bona fide commercial reasons.

This applies whether the restructuring involved is either:

- a simple alteration of the terms of a lease, or
- an agreement to terminate a lease and replace it with a lease of the same asset between the lessor and lessee (or persons connected to either party).

This provision applies to restructurings occurring after 11 April 1994 and treats both the new and the old lease as a relevant lease, even where the original lease commenced before that date.

If a lease is a relevant lease by virtue of this section, any allowance previously granted which would be available to a relevant lease is withdrawn. The withdrawal takes places in the chargeable period in which the restructuring takes place. It is the lessor's responsibility to include in the tax return for that year:

- details of the event giving rise to the withdrawal, and
- the amount to be treated as income as a result of the withdrawal.

The amount of the relief to be withdrawn is subject to interest. This is calculated using the formula:

$$A \times \frac{R}{100} \times M$$

Where:

A is the amount to be withdrawn
R is 0.0273
M is the number of days in the period beginning on the date on which tax for the chargeable period in which the allowance was made was due and payable and ending on the date on which tax for the chargeable period for which the withdrawal of the allowance is to be made is due and payable.

9.1 2006 Amendments

The restructuring provisions were relaxed as follows in Finance Act 2006.

Subsection (4A) provides that where a lease entered into before 2 February 2006, which would have been a relevant lease except for the fact that:

- the lease was entered into before 23 December 1993, or
- the lease was subject to the grant aid provisions (all of which are now obsolete),

the lease may generally continue to be a relevant lease even where the terms of the lease are altered.

The alteration is also to be ignored when considering the tax treatment of any defeasance payments under such leases except where the alteration gives rise to a reduction in the value of the non-variable lease payments.

The above rules do not apply if the alteration results in a lease payment being deferred for more than 20 years (i.e. made more than 20 years after the time that it would otherwise have been payable had the alteration not taken place).

10 Case IV Lessors

Paragraphs (b) and (c) of subsection (2) deal with the tax treatment of excess capital allowances arising from Case IV balloon leases.

As noted in Part A of this manual, where a taxpayer carries on activities that are taxed under Case IV and claims capital allowances in respect of those activities, sections 305 (individuals) and 308 (corporate taxpayers) normally allow any excess capital allowances to be offset against the current year profits or the prior year profits before being available for carry forward.

The amount carried forward can only be used against "income of that specified class" being similar income in subject to the same case. In the case of lessors of plant and machinery, this refers to any Case IV lease income.

Subsection (2)(b) restricts the relief which would otherwise be available in respect of an asset let under a balloon lease, under section 305(1)(b) for individuals or sections 308(4) or 420(2) for corporates. This means that where a taxpayer has excess Case IV capital allowances in a period, such allowances:

- may only be carried forward for use against future Case IV leasing profits, and
- cannot be offset against current or prior year profits (whether or not such profits related to leasing profits taxable under another case).

In the case of corporate lessors, subsection (2)(c) further provides that excess capital allowances arising from a Case IV balloon lease may only be offset against other Case IV balloon leases in the company (i.e. balloon lease income is recognised as a separate specified class of income for the purpose of the offset of excess balloon allowances only).

Companies can set excess capital allowances from non-balloon Case IV leases against Case IV income from balloon leases.

Appendix A – Relevant Amount of the Loss – Corporate Traders

The following scenarios set out how to calculate the relevant amount of the loss for corporate traders in a variety of scenarios.

Scenario 1

Where there is no actual trading loss and there are no capital allowances other than specified capital allowances, the relevant amount of the loss is the full amount of the loss.

Trading Profits of Leasing Trade	€100
Specified Capital Allowances	(€300)
Loss	(€200)

Here, the specified capital allowances are allowed, as to €100, to offset the €100 leasing income and the balance of €200 is restricted.

None of the provisions of subsection (4)(b) would operate to give a lesser restricted amount.

The loss may be carried:

- back against leasing income of a preceding accounting period under section 396(2) (if such income has not already been offset by capital allowances or other reliefs), or
- carried forward under section 396(1) against future leasing income.

Scenario 2

Where there is an actual trading loss and there are no capital allowances other than specified capital allowances, the restriction applies only to the amount of the specified capital allowances.

Trading Loss of Leasing Trade	(€50)
Specified Capital Allowances	(€100)
Loss	(€150)

The full amount (€100) of the specified capital allowances is the relevant amount of the loss, because it is less than the whole loss of €150.

Scenario 3

There is no actual trading loss but there are both specified capital allowances and other capital allowances.

Trading Profit of Leasing Trade		€100
Specified Capital Allowances	(€500)	
Other Capital Allowances	(€200)	(€700)
Loss		(€600)

In this case €100 of the €500 specified allowance is, in effect, set off against the €100 profit. The restriction applies not to the whole loss of €600 but only to the amount (€400) by which the loss (€600) exceeds the other capital allowances (€200).

No restriction applies to the other €200 of the €600 loss, that is, an amount equal to the other ("unspecified") allowances.

Scenario 4

There is an actual trading loss and there are both specified and other capital allowances.

Trading Loss of Leasing Trade		(€150)
Specified Capital Allowances	(€450)	
Other Capital Allowances	(€100)	(€550)
Loss		(€700)

In this case the whole of the specified capital allowance is restricted (€450) rather than the full loss of €700.

Scenario 5

Where the loss is less than or equal to the "unspecified" capital allowances, no amount of the loss falls to be restricted.

Trading Profit of Leasing Trade		€500
Specified Capital Allowances	(€400)	
Other Capital Allowances	(€200)	(€600)
Loss		(€100)

No part of the €100 loss is restricted because the specified capital allowances (€400) can be fully absorbed by the leasing profits (€500). In this case the loss (€100) is less than the other capital allowances.

Scenario 6

Trading Profit of Leasing Trade		€500
Specified Capital Allowances	(€500)	
Other Capital Allowances	(€100)	(€600)
Loss		(€100)

Again, no restriction applies because the loss is equal to the other capital allowances. The trading profit (€500) is capable in this case also of absorbing the full specified capital allowances (€500).

The non-application of the restriction would not apply if the loss exceeded the other capital allowances because the trading profit would not, in that case, have absorbed the whole of the specified capital allowances so that some part of the loss would fall to be restricted.