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IFRS 16: Leases, tax impact

IFRS 16 provides for fundamental changes to lease accounting for lessees as virtually all leases are brought on balance. Action is required; implementation as of January 1, 2019.

Background

In 2016, the International Accounting Standards Board's issued IFRS 16, leases (hereinafter: 'IFRS 16'). The implementation date (annual periods beginning on or after January 1, 2019) is approaching fast. Under IFRS 16 nearly all leases will be recognized on the balance sheet of lessees. The changes are driven by the desire to enhance comparability of financial statements between entities that own assets and entities that lease assets. The new standard significantly affects the balance sheets, income statements and financial ratios such as EBITDA and EBIT. Which in their turn might impact taxation, tax accounting and transfer pricing.

Highlights IFRS 16 tax (accounting) impact

- A right of use (hereinafter: ROU) asset and a lease liability are recognised on a lessee's balance sheet for virtually all leases (including operating leases);
- Lease expenses move from operating expenses to depreciation and interest cost, impacting financial indicators;
- IFRS 16 may or must be followed for tax purposes in some jurisdictions. In other jurisdictions lease cost may be tax deductible on a cash basis or otherwise;
- The interest and or depreciation components of the lease expense may be subject to interest limitation rules;
- The change in financial ratios such as EBIT, EBITDA and debt equity ratios may impact interest limitation rules;
- The increase of (operational) assets on the balance sheet may impact taxation and transfer pricing.
- The tax department should determine the tax base of the lease asset and liability and consider the expected IAS 12 amendments in that respect.

Implications

The new lease accounting rules could significantly impact the balance sheet and income statements of lessees with considerable off balance (operating) leases. As under IFRS 16 all leases apart from low value and short term leases are brought on balance. Entities recognise a ROU asset which is depreciated in a straight line and a lease liability which is discounted under the effective interest method. Resulting in a depreciation and interest expense rather than an operating expense (under IAS 17). This will typically result in higher lease expenses during the early years of the lease (frontloading of lease expenses) and causes the value of the ROU asset and lease obligation to diverge over the duration of the lease contract. The changes in lease accounting may also impact financial indicators such as EBIT, EBITDA debt and equity.

The new lease accounting rules significantly impact financial indicators such as EBIT(DA) and debt which could trigger tax rules in the relevant countries.

Tax effect

The tax treatment of leases differs per country. While many countries currently allow tax deductions for (operating) leases on a cash base, some countries may change their legislation upon introduction of IFRS 16.

In case in a country IFRS 16 is followed for tax purposes it should be considered if the interest and deprecation components of the lease expense are subject to limitation under the local tax law.

As the lease accounting rules also impact EBIT, EBITDA, debt and possibly equity, fiscal rules based on these indicators may be impacted as well. If tax legislation is based on the commercial indicators this also applies if tax does not align with IFRS 16.

The introduction of the ROU asset could impact tests which are based on the amount of (operational) assets on a company's balance sheet, such as the asset test under the Dutch participation exemption.

Tax accounting impact
The introduction of IFRS 16 will also impact tax accounting as, depending on the local tax law, deferred tax and the ETR may be impacted.

In March and June 2018 the IFRIC published staff papers in which the view was taken that in order to determine the tax base of the lease asset and lease liability an entity should allocate the available tax deductions either to the ROU asset or to the lease liability depending on local tax law. Depending on the allocation a temporary difference could either arise upon initial recognition, subject to the initial recognition exemption or in subsequent periods. As a result there is a difference in tax accounting depending on the allocation of the tax base.

To take away this difference the IFRIC staff proposes a narrow scope amendment to IAS 12 which entails that the initial recognition exemption should not be applicable in relation to lease contracts in the event the lease contracts give rise to both deductible and taxable temporary differences to the extent that an entity recognises a deferred tax asset and deferred tax liability of the same amount. This recommendation will be discussed by the IASB. So, the finalization has to be awaited.

Wat is a lease?

Under IFRS 16 a contract is, or contains a lease, if the contract provides a customer with the right to control the use of the identified asset for a period of time in exchange for a consideration. As a result, many rental contracts, for instance the rent of your office constitutes a lease under IFRS 16. Determining the completeness of the lease portfolio as well as the accuracy and completeness of the lease data, may require considerable effort. Any error would potentially also impact income tax.

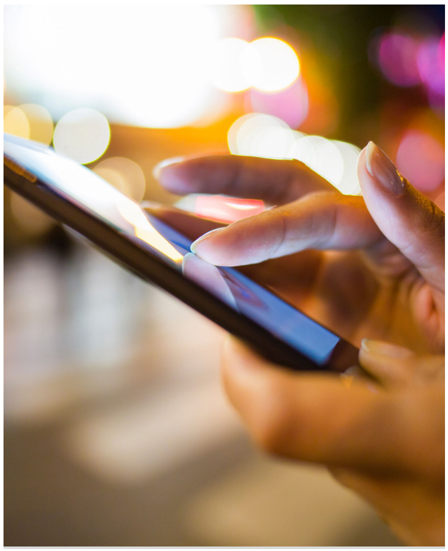
Other impact

Variable lease payments and service costs are not considered for the calculation of the asset and liability which are based on the present value of the lease cost. Hence the composition of the lease fee and duration of the contract influence the lease asset and liability and therefore the tax line. Upon transition to IFRS 16 a cumulative result may be reported the opening balance equity. It should be considered if this can be followed for tax purposes.

Action required

The transition to IFRS 16 requires the tax department survey relevant jurisdictions to determine as to whether IFRS 16 is the starting point for the tax computation and if specific tax rules are applicable to the lease expense. Furthermore it should be determined if changes to indicators such as EBIT, EBITDA, debt and equity impact the tax expense.

Finally, based upon the local tax treatment, the tax accounting impact should be determined.



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