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IFRS 16 Consultations – December 2017

Leasing: Tax response to IFRS 16 accounting changes

Despite the Government's intention that the legislative changes proposed as a response to IFRS 16 would ensure that the leasing rules continue to work as originally intended, the new consultations published have a significant impact on the 'status quo' rules for lessees and have a much wider tax impact than originally expected.

Background

The International Accounting Standards Board issued IFRS 16 Leases ('IFRS 16' or 'the new standard'), which requires lessees to recognise assets and liabilities on their balance sheet for most leases. For lessors, there is little change to the existing accounting rules for IAS 17.

The new standard will be effective for periods beginning on, or after, 1 January 2019. Early adoption is possible, provided the new accounting standard, IFRS 15 Revenue from Contracts has been applied, or is applied at the same time as IFRS 16. Early adopters will need to make adjustments to their accounts to calculate taxable profits for the 2018 accounting period.

The issue

Following a consultation in August 2016, HMRC indicated that the Government would maintain the current system of lease taxation by making changes to existing legislation so that the rules continue to work as they do currently.

The UK's current tax legislation on leasing uses the GAAP definitions of leases in certain areas. For example, UK tax legislation has 74 references to 'operating leases' and 250 references to 'finance leases'. However, from 2019 there will be no distinction between operating and finance leases for lessees who report under IFRS. Hence, UK tax legislation will need to change to reflect this.

The Government therefore published two consultations on 1 December 2017. **The first consultation** will focus on the changes required to ensure that when there is no accounting definition for operating and finance leases, the tax legislation will continue to operate in a similar way as it does today.

The consultation applies to property leases as well as equipment leases.

The Government originally indicated that this will leave taxpayers paying the same amount of corporation tax under IFRS 16 as would have been paid under IAS 17.

However, this does not appear to be the case. For example, where an equipment lease is treated for tax purposes as a 'short' lease rather than as one entitling it to claim capital allowances, the company will be entitled to deduct rentals in the same way as they are recognised in the Income Statement. Under IFRS 16 this would mean front-loaded deductions for rental expenses (as opposed to straight-line deductions under current rules). Property lease rentals would benefit from similar front-loaded deductions.

In addition, on adoption of IFRS 16, lessees would be treated as terminating all operating leases and required to re-assess whether those leases would be a 'funding' or 'non-funding' lease had they been entered into on the adoption of IFRS 16. This is expected to result in many lessees ceasing to be entitled to capital allowances under existing long funding operating leases. This proposal would also represent a significant administrative burden for many lessees.

Furthermore, where IFRS 16 is adopted mid-lease the change in accounting treatment is likely to lead to an adjustment to brought forward reserves, in addition to the charge to profit and loss in that period. The consultation looks at the tax treatment of any reserves adjustment under the change of basis rules and proposes a solution preventing front-loaded deductions for tax.

The second consultation focuses on the treatment of leases as part of the interest restriction rules. The current interest restriction rules ('CIR') also use the accounting classifications of leases as operating and finance leases (where no distinction will exist for lessees from 2019 under IFRS).

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Currently, the finance charge element of finance leases is included as 'interest' in determining whether the 30% EBITDA restriction applies whereas the 'finance element' of operating lease rentals is not.

Any changes to the CIR will apply to all companies and not just those adopting IFRS 16. The Government has sought consultations on three options:

1. ***Follow the accounts***

   Under this option those reporting under IFRS 16 and FRS 102 would have differing tax treatments. Those reporting under IFRS 16 would recognise a finance charge for leases currently classified as operating leases whereas those reporting under FRS 102 would not. This could also result in intra-group mismatches.

2. ***Keep a distinction between operating and finance leases***

   Under this option, tax-interest would include amounts where a lessee recognises a finance charge in relation to a leased asset. However, that finance charge would not need to be included in tax-interest where the respective lessor prepares GAAP compliant accounts that do not recognise finance income in relation to that leased asset i.e. where the lessor accounts for the lease as an operating lease.

3. ***Introduce a distinction between funding leases and non-funding leases***

   Under this option, tax rather than accounting rules would be used to determine how to classify a lease. If the lease is a 'funding lease' then both a lessor and lessee would include the finance element of the rentals in tax-interest for CIR purposes. If a finance charge is not recognised in the lessee's accounts, the tax-interest expense would be the amount of finance charge that would be recognised if the lessee applied FRS 102.

Real estate

The Government have indicated in the consultation that for CIR purposes, property leases would be treated in a similar manner to equipment leases. Treating an element of property rentals as tax-interest and potentially non-deductible could have a significant impact on many companies, particularly those with large property portfolios such as retailers.

Under this option the accounting treatment would be ignored, but tax-interest for the CIR rules would still be based on the accounting measurement of the finance charge in accordance with GAAP.

Why this matters

The proposed 'status quo' option will result in tax changes for substantially all companies adopting IFRS 16 and is likely to lead to differences in the amount of tax paid, particularly in the year of adoption. We expect the following impacts on our clients:

1. ***Compliance burden***

The changes in tax legislation create an additional administrative burden on companies in re-assessing existing operating leases for tax purposes. Companies should consider extracting the information required for the tax re-assessment at the same time as the accounting information is being extracted and new systems are being designed in response to the accounting data and changes required for IFRS 16.

2. ***Transition***

The accounting method of transition (full or partial retrospective) chosen for adopting IFRS 16 will impact the amount of tax payable. Tax should therefore be considered as a factor in determining the chosen method of transition.

Responding to the consultations

We recommend companies consider the following in response to the tax changes due as a result of IFRS 16:

1. Review the consultations in detail and determine the impact of the proposed options. We recommend that the tax impact of the options are quantified as part of this exercise as well as the administrative consequences;
2. Consider the tax implications of the transition method (partial or full retrospective) to be adopted. Could the tax classifications of your leases change?; and
3. Ensure that Tax is part of any IFRS 16 implementation team and that any technology solutions being considered include tax inputs and outputs.

How PwC can help

PwC's global award-winning Asset Finance & Leasing team is widely recognised as industry leading.

Our Accounting, Taxation and Systems specialists have extensive, practical experience of working with our clients on assessing the impact of IFRS 16 and ensuring compliance, both on day one and into the future. This experience has given them detailed insights into the relevant legislation and practical solutions taken by clients.

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