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IFRS 16 - Potential tax impact of its introduction on leases in Nigeria

Newsletter

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Background

The International Accounting Standards Board (IASB) recently issued the International Financial Reporting Standard (IFRS) 16 on Leases. The IFRS, which will apply to all financial statements prepared for periods beginning on or after 1 January 2019, will replace the existing International Accounting Standard (IAS) 17.

The implementation of IFRS 16 may not substantially change the manner in which a lessor accounts for leases under the existing IAS 17. Under the IAS, the lessor will classify a lease as a finance lease where the lease agreement transfers or contemplates the future transfer of the risk and rewards due from the usage of the asset. Every other lease is classified as an operating lease. The definition of a lease under IAS 17 is more or less the same as under IFRS 16.

What is changing?

However, there is a marked difference in accounting for leases by the lessee under the IAS and the IFRS. While the IAS does not create any difference between the classification of a lease by the lessor and the lessee, the IFRS provides for a different basis for lessee accounting. Under the IFRS, the lessee is expected to, for all leases (other than leases with a duration of less than 12 months or leases for low-value assets i.e. assets whose value is $5,000 or less):

(i) Recognise an asset and a corresponding liability equal to the present value (PV) of all future unavoidable payments due on the lease.

> The impact of the above is that a substantial amount of off-balance sheet leases will now be recognised in the balance sheet of the lessee.

(ii) Recognise a depreciation expense and an interest expense separately in the income statement.

(iii) Separate the total amount of cash paid into a principal portion (presented under financing activities) and interest (typically presented either under operating or financing activities) in the cash flow statement.

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Key tax issues

It is therefore important to consider the potential tax implication of this change for the lessee. Paragraph 18 of the Second schedule of the Companies Income Tax Act (CITA) contains provisions, which guide the tax treatment of leased assets. In summary, the Paragraph provides that the lessor would continue to claim capital allowance at the prescribed rate on assets on operating lease while the lessee would claim capital allowance on assets finance lease.

The Paragraph and or the entire CITA does not define the terms finance or operating leases. It only states that these terms would have the same meaning ascribed to them in the relevant accounting standard.

Given that IFRS 16 does not change the definition of both terms, it may be easy to conclude that nothing much will change from a tax perspective. However, it is not so clear cut. Where a lease under the terms of the transaction qualifies as an operating lease, the lessor will continue to claim capital allowance on the asset throughout the duration of the lease. However, under the IFRS, the lessee would have capitalized the same asset, recognised a depreciation expense and an interest expense.

Based on Section 27 of the CITA, the depreciation expense would be disallowed. Also, given that the lease remains an operating lease despite the new basis for recognition and accounting, it can be argued that the lessee should not be

able to claim capital allowances on the value of the asset recognised. This would therefore serve as double jeopardy for the lessee. It would only be fair for the lessee to be allowed to claim capital allowances.

Nothwithstanding, the value it can can derive from claiming capital allowances would be dependent on law rather than actual payments made on an annual basis. To put this in proper perspective, a company which takes out a lease on a car would have to capitalize the value of the payments due and take benefit for it over a 4 year period (the duration of the useful life of a motor vehicle for capital allowance purposes). Thus, there may be a mismatch in the annual payment made and the tax benefit obtained in the same year. Though, this will more or less even out with the recognition of a deferred tax asset or liability, there may still be significant impact on cash flow.

Furthermore, the depreciation charge is typically even, while the interest expense which is tax deductible reduces over the life of the lease as lease payments are made. This may result in a reducing total expense as the individual lease matures,[1] thus ensuring that more taxes are paid in the later years of the lease. However, the difference in the expense profile between IFRS 16 and IAS 17 may not be significant for companies holding a portfolio of leases that start and end in different reporting periods.

There is also the issue of recognition. Given that the assets would be capitalized, tax managers and advisers may need to query all additions to the fixed asset to determine their nature and ensure that the proper treatment is accorded them. This is even more so where the company and or its auditors have not included relevant notes in the financial statements.

Indirect tax will also be another critical issue after the change. Currently, the Federal Inland Revenue Service (FIRS) requests companies to account for value added tax (oil and gas companies) and withholding tax on all additions to fixed asset. This approach clearly would be wrong in this particular instance, as additions to fixed asset will comprise the ***present value*** of future unavoidable payments as opposed to actual payments in a period which arguably should be the base for the application of relevant indirect taxes. Also, the recognition of an interest expense is sure to attract the attention of the FIRS even though the amount recognised may be different from the amount paid. The critical issue would be whether the obligation to withhold tax on the periodic lease rental ***payments*** will continue to subsist under the proposed arrangement or whether the obligation will only be restricted to the interest portion recognised in the profit and loss statement for the specific period.

Notwithstanding, there is clearly a need to keep additional accounting information which shows the relationship between the periodic rental payments and the depreciation and interest expense recognised in the books for review by tax managers, advisers and authorities in order to ensure that the proper treatment is accorded the relevant items.

Conclusion

It is clear that a lot of study and discussion needs to take place between now and the effective date of implementation of the IFRS. Companies with significant off-balance sheet leases would need to consider the impact of the change on their cash flow position and determine how best to manage it. The companies and the tax authority would also need to consider the potential impact on tax reporting and agree on what additional tax reporting requirements would be required as well as the treatment of some of the contentious issues.

We do not need to wait till 2019 to start the discussions. It is imperative that we start these discussions now so we are prepared by the due date.

[1]IFRS 16 – Effects Analysis

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