

In Confidence

Office of the Minister Revenue

Chair, Cabinet Economic Development Committee

INCOME TAX TREATMENT OF LEASES SUBJECT TO NZ IFRS 16

Proposal

1. This paper seeks the Cabinet Economic Development Committee's agreement to allow taxpayers who follow International Financial Reporting Standards (IFRS) to choose to follow their accounting treatment, with certain adjustments, for calculating tax deductions for expenditure under operating leases other than real property.¹
2. Cabinet approval is sought as this is a policy change to the timing of lease deductions which will potentially affect all IFRS taxpayers and has a \$9 million fiscal cost over 5 years.

Executive Summary

3. Taxpayers who have IFRS reporting obligations² are required to follow the new accounting standard *New Zealand Equivalent to International Financial Reporting Standard 16 Leases* (NZ IFRS 16 or IFRS 16) for years starting on or after 1 January 2019.
4. IFRS 16 changes the timing of accounting expenditure for lessees (the person with use of the asset) compared to the previous treatment; but total deductions are unchanged over the life of the lease. I propose that lessees who follow IFRS should be able to elect to follow, subject to certain adjustments, their IFRS 16 treatment when calculating income tax deductions on operating leases other than real property.
5. Allowing these taxpayers to follow their IFRS 16 treatment will more closely align the tax treatment with other methods of acquiring assets such as a finance lease or a debt funded outright purchase. It will also reduce compliance costs, and the possibility of inadvertent errors, from having to back out accounting expenditure and calculate a separate tax deduction.

Background

6. A lease involves one person (known as the lessor) who owns (or otherwise holds) an asset providing it to another person (known as the lessee) to use in exchange for payment over the term of the lease. For entities with IFRS reporting obligations, the accounting treatment was previously determined under *New Zealand Equivalent to*

¹ Real property is a commonly used term that essentially relates to land and buildings.

² The requirement to prepare accounts under IFRS varies but the most common is having total assets in excess of \$60 million or total revenue in excess of \$30 million. In 2017 the External Reporting Board (XRB) identified 2,575 entities with IFRS reporting obligations based on 2015 data.

International Accounting Standard 17 Leases (NZ IAS 17). This standard has been replaced by IFRS 16 for years starting on or after 1 January 2019.

Accounting treatment under NZ IAS 17

7. Under NZ IAS 17, there was a difference in the accounting treatment between operating and finance leases. NZ IAS 17 defined the distinction as follows:

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

8. For example, a lease would be a finance lease if the lessee leased the asset for the majority of its estimated useful life then had the right to purchase it from the lessor for a fixed price at the end of the lease. In contrast, a lease would be an operating lease if the lessee only leased the asset for a short portion of the estimated useful life then at the end of the lease it was returned to the lessor to lease or sell to someone else.

Current tax treatment

9. The Income Tax Act 2007 contains two separate sets of rules for finance and operating leases. These definitions are similar, but not identical to, the NZ IAS 17 definition. The largest difference is that all leases of real property are operating leases for tax purposes. For finance leases, the lease payments are taxed under the financial arrangements rules and are treated like the repayment of a loan with interest. For operating leases, the lease payments are currently spread equally over the life of the lease. This treatment is similar to the NZ IAS 17 accounting treatment which reduces the need for tax adjustments.

Accounting changes moving from NZ IAS 17 to IFRS 16

10. For lessees, IFRS 16 removes the distinction between operating and finance leases for accounting purposes. Under IFRS 16, lessees are required to recognise on their balance sheet a new asset, being the right to use the leased asset for the lease term, and a lease liability representing the obligation to pay rentals.
11. Under IFRS 16, there is usually a slight acceleration of deductions compared to accounting under NZ IAS 17. This can be shown in the following simplified example for a 5-year lease, that was an operating lease under NZ IAS 17, with \$100,000 per year of lease payments and a 3.7237% discount rate:

Year	NZIAS 17 Expense s	IFRS 16 Expense s
1	100,000	106,439
2	100,000	103,337
3	100,000	100,120
4	100,000	96,783
5	100,000	93,322
Total	500,000	500,000

12. The NZ IAS 17 treatment matches the cashflows of the lease, whereas IFRS 16 more closely matches the economic cost of the lease. The IFRS 16 treatment can be thought of similar to a typical fixed-rate mortgage where total payments are consistent over time, but the interest expenditure is higher in earlier periods when the loan is higher, and the interest expenditure is lower (and therefore capital repayments are higher) near the end of the loan when the amount outstanding is lower.
13. IFRS 16 does not significantly change the accounting treatment of leases for the lessor. The lessor will continue to reflect the leased asset on their balance sheet for operating leases. This Cabinet paper does not consider changes to the tax treatment of lessors.

Comment

14. The introduction of IFRS 16 provides an opportunity to more closely align the tax and accounting treatment of lessees' operating leases. I propose this be optional for all lessees that follow IFRS 16. This will achieve two main objectives:
- 14.1. Efficiency - As finance leases and debt used to purchase assets are already taxed under the financial arrangements rules, deductions are accelerated similar to the IFRS 16 example above. Aligning the tax treatment of operating leases with the IFRS 16 treatment will make the tax treatment of all three methods of asset acquisition more similar which will reduce the tax incentive to choose one method over another to obtain a tax advantage.
- 14.2. Compliance costs - Unlike when entities followed NZ IAS 17, an entity following IFRS 16 will need to make tax adjustments to remove accounting deductions and claim tax deductions. By following IFRS 16 for tax the number of adjustments required can be reduced and therefore compliance costs will be lower as will be the possibility of inadvertent error.
15. This option will only be available to taxpayers who follow IFRS 16 for accounting purposes. The calculation of expenditure under IFRS 16 is sufficiently complex that I do not recommend allowing a non-IFRS taxpayer to undertake these calculations solely for tax purposes. Instead these taxpayers, and any IFRS taxpayer who chooses not to follow their account treatment for tax purposes, should continue to follow the existing method.

Adjustments between accounting and tax

16. There are certain accounting entries required to be made under IFRS 16 that spread expenditure over the (remaining) term of the lease that should be recognised differently for tax purposes. This is because expenditure for tax purposes is typically deductible when it is incurred and allowing a deduction over the life of the lease would offer a more favourable tax treatment compared with taxpayers that do not follow IFRS 16 or have not elected to follow IFRS 16 for tax purposes.
17. The adjustments that should be made between the IFRS 16 and tax treatment are:
 - 17.1. Impairment, fair value and revaluation costs – these are essentially a provision against future events and for tax purposes they should be deductible when (and if) they are incurred.
 - 17.2. Make good costs – these are the costs of restoring an asset before it is returned to the lessor and for tax purposes should be deductible when they are incurred which is typically near or at the end of the lease.
 - 17.3. Direct and mobilisation costs – these are the costs of entering into a lease and for tax purposes should be deductible when they are incurred which is typically at or near the start of a lease³. To minimise compliance costs this adjustment should be at the option of the taxpayer.
18. The exclusion of real property leases, which is discussed further below, should significantly reduce the number of adjustments that taxpayers are required to make.

Leases that will be covered by the election

19. This election to follow the IFRS 16 treatment for tax purposes will apply only to operating leases, using the existing tax definition of operating lease. This definition achieves a similar outcome to the accounting definition, in paragraph above, with the largest difference being all leases of real property must be a tax operating lease. There are some exceptions to this, discussed below, where operating leases should continue to follow their existing treatment.

Real property

20. The election to follow the IFRS 16 treatment for tax purposes should not apply to leases of real property and they should instead continue to follow their existing tax treatment.
21. There are several reasons for this including:
 - 21.1. there is less efficiency benefit from this alignment as leases of real property cannot be a tax finance lease; and

³ Some direct costs are already incurred over the term of the lease. For these costs the IFRS 16 and tax treatment will already align so no further adjustment will be required.

- 21.2. leases of real property typically have many more accounting features, as discussed at paragraph above, that would need to be adjusted for tax purposes. By excluding real property compliance costs will be much lower and the proportion of taxpayers choosing to follow their accounting treatment for tax purposes is expected to be higher.
22. Many businesses will have more non-real property leases than real property leases. However, real property leases are typically for longer terms and over higher value assets, so the total value of real property leases is expected to be far higher. Excluding real property significantly reduces the fiscal cost of the proposals.

Leasing to associated persons and sub-leasing

23. When a taxpayer has an asset they lease to an associated party this would create a tax timing benefit to those two taxpayers when considered as a group if they could follow the IFRS 16 treatment for tax.
24. This timing benefit also arises when a taxpayer leases an asset from another person and then sub-leases that asset.
25. These issues arise as IFRS 16 applies a different method to spread income for lessors and expenses for lessees.
26. To prevent this mismatch, the existing tax treatment should continue to apply if:
- 26.1. a taxpayer leases an asset then sub-leases it to another person; or
 - 26.2. a taxpayer leases an asset from an associated party.

Equipment leases

27. Aside from real property, the other common high value assets subject to leases are large equipment such as aircraft. These are typically treated as tax finance leases so will not be affected by the recommendations in this paper. If high value equipment is leased under a tax operating lease by a taxpayer who has chosen to follow the IFRS 16 treatment for tax then they should also be able to follow the IFRS 16 treatment for that equipment.

Further details

28. Once a taxpayer elects to follow IFRS 16 for tax they should be required to continue this treatment in all future periods except when they cease to follow IFRS 16 for accounting purposes.
29. A taxpayer electing to follow IFRS 16 for tax will typically incur a one off deduction arising from expenditure that was not deductible under NZ IAS 17 or the former tax treatment but would have been deductible if they have been able to follow IFRS 16 in earlier periods. To minimise the upfront impact on tax revenue I recommend this deduction be spread over five years.
30. When a taxpayer ends a lease or stops applying IFRS for accounting they should calculate a wash-up to ensure total tax deductions are the same as those incurred by

a taxpayer who is not following IFRS 16 for tax. When a lease ends after following its full intended term this wash-up will typically be zero.

Consultation

31. Targeted consultation has been undertaken with affected taxpayers, representative bodies and their advisors. They are supportive of proposals to allow closer alignment of tax and accounting operating lease expenditure for lessees following IFRS.
32. The Treasury has been consulted and support the proposals.

Financial Implications

33. The fiscal impact of the changes is a revenue loss of approximately \$1.8 million per year for 5 years, with a corresponding impact on the operating balance:

Vote Revenue Minister of Revenue	\$m – increase/(decrease)			
	2019/20	2020/21	2021/22	2022/23 & Outyears
Tax Revenue	(1.800)	(1.800)	(1.800)	(1.800)
Total Operating	(1.800)	(1.800)	(1.800)	(1.800)

34. The cost of this proposal can be accounted for on the tax policy scorecard.
35. The current scorecard balance to the end of the 2022/23 fiscal year is \$51.806 million. The implementation of this policy would reduce the cumulative scorecard balance to \$44.606 million. There are currently no other upcoming items on the scorecard.
36. As expenditure by lessees will continue to be deductible, and these proposals only change the timing of those deductions, this proposal will have no direct effect on tax revenue after the five-year transition period ends in 2023/24.

Legislative Implications

37. Implementing these proposals will require changes to the Income Tax Act 2007. I recommend that the necessary amendments are included in the next omnibus taxation bill scheduled for introduction in early-2020 with effect from the 2019-20 income year.

Impact Analysis

38. A Regulatory Impact Assessment (RIA) is attached.
39. The Quality Assurance reviewer at Inland Revenue has reviewed the *Income tax treatment of leases subject to NZ IFRS 16* RIA and considers that the information and analysis summarised in it **meets** the quality assurance criteria of the Regulatory Impact Analysis framework.

Human Rights

40. There are no human rights implications arising from the proposals in this paper.

Gender Implications

41. There are no gender implications arising from the proposals in this paper.

Disability Perspective

42. There are no specific disability considerations arising from the proposals in this paper.

Publicity

43. Inland Revenue will make an announcement on this policy once Cabinet decisions have been made. I will also make an announcement about the introduction of the bill which will contain this proposal. A commentary on the bill will be released at this time.

Proactive Release

44. I propose to proactively release this Cabinet paper, associated minutes, and RIA in whole within 30 working days of Cabinet making final decisions.

Recommendations

The Minister of Revenue recommends that the Committee:

1. agree that the tax treatment for lessees of operating leases that are not real property, leased from an associated party or sub-leased should be amended to follow IFRS 16 for taxpayers who choose to do so.
2. agree that taxpayers following recommendation 1 should be required to make adjustments to ensure certain operating lease expenditure continues to be tax deductible close to when it is incurred.
3. agree that expenditure arising from the transition to the IFRS 16 method for tax should be spread over five years.
4. agree that recommendation 1 to 3 should apply for the 2019-20 and later income years.
5. note that agreeing to recommendation 1 to 4 above will have an estimated revenue cost of \$7.200 million over the forecast period,

Vote Revenue Minister of Revenue	\$m – increase/(decrease)			
	2019/20	2020/21	2021/22	2022/23 & Outyears
Tax Revenue	(1.800)	(1.800)	(1.800)	(1.800)
Total Operating	(1.800)	(1.800)	(1.800)	(1.800)

6. note that the final year of fiscal impact outlined in recommendation 5 is 2023/24.
7. agree that the changes recommended above be included in the next available omnibus tax bill

Authorised for lodgement

Hon Stuart Nash

Minister of Revenue