Policy and Strategy
Inland Revenue

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Proposed changes to the income tax treatment of leases where IFRS 16 applies

The Government has agreed to proposed changes that would allow taxpayers who apply the *New Zealand Equivalent to International Financial Reporting Standard 16 Leases* (NZ IFRS 16 or IFRS 16) to more closely follow their accounting treatment of leases for tax purposes.

The proposed changes will be included in a tax bill in early 2020, and would apply for income years starting on or after 1 January 2019.

Background

The Government has agreed to proposed changes that would allow qualifying taxpayers to more closely follow their accounting treatment of leases for tax purposes, if they choose to do so.

The proposed tax changes result from the replacement of the previous accounting standard for leases, *New Zealand Equivalent to International Accounting Standard 17 Leases* (NZ IAS 17), with *New Zealand Equivalent to International Financial Reporting Standard 16 Leases (*NZ IFRS 16 or IFRS 16*)*. IFRS 16 applies to income years starting on or after 1 January 2019.

The proposed rules will be included in a tax bill planned for introduction in early 2020. They would apply to taxpayers with IFRS reporting obligations for income years starting on or after 1 January 2019, to align with the commencement of IFRS 16.

Summary of the proposed changes

No changes for non-IFRS taxpayers

No changes are proposed to the tax treatment of leases for taxpayers that do not have IFRS reporting obligations.

Updates to the tax definition of finance leases and operating leases

The definition of finance lease in section YA 1 of the Income Tax Act 2007 refers to NZ IAS 17. The proposed changes would update the definition to refer to IFRS 16.

No changes are proposed to the existing boundary between finance leases and operating leases for tax purposes.

Finance leases and the yield to maturity method

Section EW 15I allows a person who has a tax finance lease that is classified as an operating lease under NZ IAS 17 to apply the yield to maturity method. IFRS 16 removes the accounting distinction between operating and finance leases for lessees. However, the yield to maturity method will continue to be available for these leases.

Lessors under tax operating leases for IFRS taxpayers

No changes are proposed to the tax treatment of lessors.

Lessees under tax operating leases for IFRS taxpayers

The proposed changes are optional. IFRS taxpayers who choose not to align with IFRS 16 for tax purposes can continue to follow their existing treatment.

Optional election

A taxpayer that applies IFRS 16 can make a one-off choice to more closely align their accounting and tax treatment of operating leases for tax purposes.

It is proposed that the election would be made by calculating deductions using the proposed rules in the income tax return for the year the choice is made. No separate election would be required. Once a taxpayer makes this choice they will have to continue to follow this method in all future years where they follow IFRS 16 for accounting purposes.

Leases within the scope of the proposed rules

A taxpayer choosing to align with IFRS 16 for tax purposes would be required to follow the proposed rules for all tax operating leases where they are the lessee. This would apply to all existing leases at the time the choice is made, as well as all operating leases entered into after this.

However, it is proposed that a taxpayer would continue to follow their existing treatment for the following tax operating leases:

- a lease of real property;
- a lease from an associated party; and
- a lease where the asset is subleased.

Real property

The Income Tax Act 2007 already treats all leases of real property as an operating lease. The proposed rules carve out real property, using the existing boundary, so that a lease of real property will continue to follow the existing treatment even when a taxpayer has chosen to align with IFRS 16 for tax purposes for other leases.

Associated parties

The different treatment between lessors and lessees under IFRS 16 means that if a taxpayer could choose to align with IFRS 16 for tax purposes for an asset they leased to an associated party, it would result in a tax timing advantage compared to retaining it in the first taxpayer. To prevent this scenario the proposed rules continue to use the existing tax treatment for all operating leases from an associated party.

Two unassociated parties might enter into an operating lease under the proposed rules and then subsequently become associated, for example because of a change in shareholding. It is proposed that the tax treatment of that lease would revert to the existing treatment including an adjustment, as described in the ceasing to be a lessee to a qualifying lease section.

Subleases

Under IFRS 16, when an asset is subleased to a second person the asset in the first person's balance sheet changes from a right-of-use asset to a lease receivable where the sublease of the lessor is a finance lease for accounting. If the tax treatment followed the accounting treatment, a taxpayer would not be entitled to deductions for the amortisation of the right-of-use asset. To resolve this situation the proposed rules continue to use the existing tax treatment for all operating leases when the asset is subleased to another person.

If an asset is subleased to another person part way through a lease term, then the tax treatment of that lease would have to revert to the existing treatment and include an adjustment, as described in the ceasing to be a lessee to a qualifying lease section. Officials expect that the exclusion of real property leases from the new rules will significantly reduce this situation occurring.

Transitional adjustment

A taxpayer that chooses to align with IFRS 16 for tax purposes must calculate the difference between its current tax treatment and the IFRS 16 treatment for all previous periods for all outstanding leases. Officials expect taxpayers will typically calculate this adjustment in the year they first follow IFRS 16 for accounting purposes. However, it could be a subsequent year if the taxpayer chooses to do so.

The transitional adjustment may be deductible expenditure or assessable income. In either case this should be spread equally over the year the choice to align with IFRS 16 for tax purposes is made and the four subsequent years.

A taxpayer choosing to align with IFRS 16 for tax purposes will calculate a single transitional adjustment to be spread over five years – this would include leases that will mature before the end of that five year period.

Leases that do not follow IFRS 16

A taxpayer that follows IFRS 16 for accounting may have individual leases that are not accounted for by following IFRS 16. Examples of this include certain low-value or short-term leases. It is proposed that if these leases would qualify under the new rules (that is, they are a tax operating lease that is not providing real property, with an associated party or a sublease) this non-IFRS 16 treatment will also be acceptable for tax purposes. Officials expect the accounting treatment for these specific leases will be similar to the existing tax treatment.

Adjustments

The proposed rules are not intended to significantly accelerate tax deductions compared to those available under the existing rules.

It is proposed that tax adjustments set out in Table 1 may be required where a taxpayer has chosen to align with IFRS 16 for tax purposes and there are amounts that are spread.

Table 1: Results of spreading and the proposed tax adjustments that may be required

If the spreading results in accounting deductions that are…	...then it is proposed that a tax adjustment is made.
in advance of when the expenditure is incurred (for example, impairment, fair value or revaluation amounts or make good costs)	• to ensure that tax deductions are only available in a similar period to when the expenditure is incurred.
later than when the expenditure is incurred (for example, certain direct or mobilisation costs)	• to ensure tax deductions are available in a similar period to when the expenditure is incurred, and • it would be optional, so that a taxpayer who would incur higher compliance costs in making the adjustment than the perceived value of that adjustment will not be required to do so.

Officials are still finalising the exact details of how these adjustments would be calculated. Further details will be available in the bill containing the proposals when it is introduced, and the associated bill commentary. Officials expect the exclusion of real property from the proposed rules will significantly reduce the number of tax adjustments required.

Ceasing to be a lessee to a qualifying lease

When a taxpayer ceases to be a lessee to a qualifying lease, it is proposed that they calculate an adjustment to ensure total deductions match what would have been available under the existing tax treatment. This adjustment would be similar conceptually to a base price adjustment under the financial arrangement rules.

The adjustment would be required when:

- the lease matures;
- the lease ceases to qualify because the lessee and lessor have become associated;
- the asset has been subleased to another person; or
- the lessee ceases to follow IFRS 16 for accounting.

Officials expect the result of this adjustment to typically be zero when a lease runs for its full term.

Application date

It is proposed that the rules would apply to income years starting on or after 1 January 2019, to align with the application date of IFRS 16.

It is possible for taxpayers to elect to apply IFRS 16 for earlier years, and officials are aware that a small group of taxpayers have done so.

Taxpayers who have elected to apply IFRS 16 in earlier years would typically be expected to file their tax returns on or before 31 March 2020. It is not possible for the bill containing these proposals to be enacted before this date.

Officials consider it would be desirable for the new rules to also be available in the year of adoption for taxpayers who elect to adopt IFRS 16 early. We will work with affected taxpayers to determine the best way to resolve this.