Lease Accounting Changes: Tax Response

ICAEW welcomes the opportunity to comment on the discussion draft *Lease Accounting Changes: Tax Response* published by HM Revenue & Customs on 9 August 2016.

This response of 28 October 2016 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

Contents

The Institute of Chartered Accountants in England and Wales
Chartered Accountants' Hall
Moorgate Place London EC2R 6EA UK
icaew.com/taxfac

T +44 (0)20 7920 8646
F +44 (0)20 7920 0547
E taxfac@icaew.com

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 145,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

For more information, please contact ICAEW Tax Faculty: taxfac@icaew.com

icaew.com

General comments

Background

1. A new accounting standard IFRS 16 Leases will come into effect for accounting periods beginning on or after 1 January 2019 for those companies which prepare their accounts in accordance with IFRS. This includes listed UK businesses.

2. The new regime affects the accounting treatment of leases and will in the main affect lessees, who will be required to bring all but low value or short term leases onto their balance sheets. There will no longer be a distinction between finance and operating leases for lessees and the leased asset will appear on the balance sheet as a “right of use” asset, together with a lease liability reflecting the lessee’s obligation to make lease payments. ICAEW’s Financial Reporting Faculty produced an IFRS Factsheet for its members in July 2016 explaining the changes and their implications, and we reproduce in Appendix 1 extracts from the overview from that factsheet.

The current consultation

3. The current HMRC discussion draft examines the tax policy options in respect of leases of plant and machinery under the new, post-2019, regime. Leases of other assets are not part of the current consultation.

4. The discussion draft identifies four options. The first option would seek to replicate the current tax regime for expenditure on leased plant & machinery.

5. The other three options for lessors and lessees would follow the accounting treatment, with no special tax allowances under option 2, so just following the accounts, while option 3 would introduce a new, optional, “leasing allowance” available to lessees and option 4 would provide lessees with an option to claim capital allowances based on the “right of use” asset.

Companies that do not use IFRS

6. The majority of UK companies do not follow IFRS although, as mentioned above, IFRS will be followed by listed UK companies.

7. Those companies using the UK standard FRS 101, which is essentially IFRS with reduced disclosure requirements, will be required to follow the recognition and measurement requirements of IFRS 16 and so will be affected by the outcome of the current consultation.

8. Those using FRS 102, will – for now at least – continue to reflect current definitions of finance and operating leases both for lessors and for lessees. The FRC is, however, currently consulting on proposals that would see the lessee accounting requirements of FRS 102 updated for consistency with IFRS 16. The current proposals would see these amendments to FRS 102 being effective from 1 January 2022.

9. Those using FRSSE, which is the simplified version of UK GAAP available to small companies, will also continue to reflect current definitions of finance and operating leases. This standard has, however, been withdrawn for accounting periods beginning on or after 1 January 2016.

Aim of the consultation

10. In paragraph 1.11 of the discussion document, HMRC states that the key considerations that need to be “taken into account in taking the issue forward” are:

- the current and expected future commercial environment;
- simplification where possible; and
- strong protection of revenue for the Exchequer.

11. The discussion draft asks what other criterion ought to be taken into account. Clearly any new tax regime needs to provide a positive environment in which potential investment in plant and machinery is promoted and encouraged, and also investment in other assets if future consultations are widened to include other assets.

The current options

12. The four options are summarised in the discussion draft as follows

> **Option 1** - Status quo
> Minimal change to the statutory provisions to ensure that the current tax regime continues to function and deliver the same outcome for tax purposes.
>
> **Option 2** – Accounts based regime
> A new tax regime based on the accounting entries.
>
> **Option 3** – Accounts based with leasing allowance
> A new tax regime based on the accounting entries but providing an option to the lessee to claim enhanced or accelerated relief based on the value of the right to use the leased asset.
>
> **Option 4 –** Accounts based with capital allowances
> A new tax regime based on the accounting entries but providing an option to the lessee to claim capital allowances based on the value of the right to use the leased asset.

ICAEW views on the four options

13. We set out below our initial views on the four options, set out above, by reference to the discussion points in the discussion draft itself.

14. At this stage we have set out the pros and cons of the various options without being prescriptive as to the one(s) that we favour. We hope this will be helpful to HMRC in refining its own thinking on these options.

RESPONSES TO DISCUSSION POINTS RAISED IN THE DISCUSSION DRAFT

Option 1 – Status quo

Discussion Points

- **Option 1, unlike the other options involves capital allowances still being available to lessors, except under long funding leases. What merits are there in maintaining this current approach to the allocation of capital allowances?**
- **Is the current system of lease taxation well enough understood to override issues around complexity?**

15. The current regime is extremely complex and it can be onerous for lessors which have to analyse the capital allowances position for individual lease assets.

16. Were this option to be followed then we believe that, at the very least, the opportunity should be taken to seek to simplify the regime as far as possible. We do know from our contacts in the leasing industry that this is an attractive option for many.

17. But our view is that there is considerable merit in starting from the accounting treatment under the new regime to determine the tax treatment of leased assets. The alternative, option 1, would see companies effectively having to maintain separate sets of books for tax and accounting purposes, which in many cases would be very onerous, given that many large companies have many tens or even hundreds of thousands of leases.

18. So we have a strong preference for giving precedence to Options 2, 3 and 4 in the course of the continuing consultation.

19. But as a more general point, the different options are going to appeal to different taxpayers depending on their tax profile, e.g. whether they are lessee or lessor, whether they are a lessor with a deferred tax asset or deferred tax liability etc. In the course of this, and the subsequent consultations HMRC and the government will have to determine the likely impact of the various options on individual taxpayers, and sectors of the economy, and determine which option is going to be most beneficial for the economy as a whole.

Option 2 – Accounts based regime

Discussion Points

- **An accounts based regime would replace for all leased assets current access to capital allowances with accounting depreciation. What impact would this have on financing decisions and on the availability of finance?**
- **There may be circumstances where the tax treatment will need to depart from the accounting treatment to prevent abuses. How much of a burden would this present?**
- **What are the relative merits and disadvantages of this option compared to the existing regimes?**

20. This would be the most straightforward of the accounts based regimes, but we are concerned that there will be insufficient tax incentives to make this an attractive option for business and for the leasing industry.

21. If HMRC feels that there should be a considerable volume of anti-avoidance legislation to prevent abuse then this would undermine the attractiveness of this option and would add to its complexity.

Option 3 – Accounts based with leasing allowance

Discussion Points

- **If a leasing allowance were considered, would this have an impact on financing decisions?**
- **Would claiming the leasing allowance present any particular difficulties?**
- **Should a leasing allowance be available where assets of low value are leased and no right of use asset is recorded by the lessee?**
- **What do you consider are the advantages and disadvantages of the accounts based with leasing allowance option compared to maintaining the existing scheme of legislation (Option 1)?**

22. Option 3 front-loads deductions compared with option 2 but it is difficult to assess the attractiveness of this option without some more detailed information about the nature of the proposed leasing allowance.

Option 4 – Accounts based with capital allowances

Discussion Points

- **If capital allowances were made available to the lessee based on the right of use asset would this have an effect on a decision to buy or to lease an asset?**
- **If capital allowances were to be made available to lessees should this extend to cover arrangements where no right of use asset is recorded by the lessee?**
- **Should capital allowances be available where assets of low value are leased and no right of use asset is recorded by the lessee?**
- **What do you consider are the advantages and disadvantages of the accounts based capital allowances option compared to maintaining the existing scheme of legislation (Option 1)?**

23. From the examples in the discussion draft, this may be the most attractive option for the lessee but the numbers in the example suggest that the lessee will be able to claim 100% of the “right of use” value recorded in its accounts. In practice there is an annual limit of £200,000 of expenditure on which the full 100% Annual Investment Allowance is available. As the new leasing standard will be applicable to listed UK companies the majority of their expenditure on capital assets is going to be subject to writing down at, normally, 18%. So the example overstates the benefit to the lessee at the beginning of the lease period.

24. A retention of the capital allowances rules is likely to be an attractive option and one that will encourage investment in capital assets whether by way of leasing or through outright purchase.

25. We do recognise that Option 1 is also an attractive option as business is familiar with it but we do believe that it is probably going to be better to start with the new accounting regime as the basis for the new tax regime.

APPENDIX 1

ICAEW Financial Reporting Faculty – *Introducing IFRS 16 Leases* factsheet

We reproduce below extracts from the overview from the factsheet

Which standards have been withdrawn?

IFRS 16 supersedes IAS 17 *Leases* together with the related interpretations IFRIC 4 *Determining whether an Arrangement contains a Lease*, SIC-15 *Operating Leases – Incentives* and SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

Why was it necessary to replace the approach set out in IAS 17?

IFRS reporters currently account for leases under IAS 17 *Leases*, which classifies leases as either 'finance leases' or 'operating leases'. If a lease is classified as a finance lease, it appears on the balance sheet of the lessee, along with a related lease liability. If it is classified as an operating lease, the asset and liability do not appear on the lessee's balance sheet, with rental costs expensed in the profit or loss account over the lease term.

These differing treatments can be confusing for users of financial statements as economically similar transactions can be accounted for differently. They can also lead to entities 'structuring' lease arrangements to achieve a preferred accounting treatment.

How does the new standard address problems with today's lease accounting?

IFRS 16 introduces a single lessee accounting model that requires assets and liabilities arising from almost all major lease arrangements to be recognised on-balance sheet, meaning that investors will no longer need to make arbitrary adjustments to an entity's accounts to adjust for off-balance sheet items. Moreover, comparability will be improved as there will be less opportunity to structure a lease to achieve a particular accounting outcome.

How, in a nutshell, does the new lessee accounting model work?

IFRS 16 introduces a 'right of use' model under which lessees will recognise an asset reflecting their right to use the leased asset for the lease term and a lease liability reflecting their obligation to make lease payments. Both the asset and the liability will be recognised on-balance sheet at the commencement of the lease.

Will this approach apply to all leases?

No. While this approach will apply to most major leases, there are important exceptions for short-term leases and for leases of low-value assets. Certain specific leases are also beyond the scope of the standard (see below for details).

Does anything change for lessors?

IFRS 16 substantially carries forward the lessor accounting requirements of IAS 17. A lessor will therefore continue to classify its leases as operating leases or finance leases and to account for these two types of lease differently. Intermediate lessors could, however, face significant changes as a result of the new standard. Additionally, IFRS 16's new definition of a lease applies to both lessees and lessors, albeit that it is not radically different from IAS 17's previous definition.

Who will be most affected by the new standard?

The impact will vary from sector to sector and from entity to entity. It is likely to be most pronounced in those business sectors – such as transport, retail, real estate, financial services, mining and construction – in which it is common for entities to have a significant number of material off-balance sheet leases. Entities with significant leased premises will be particularly affected.

How will this affect lessees' financial statements?

The most significant effect of the new standard will be the increased number of both lease assets and lease liabilities recognised on lessees' balance sheets. This will result in potentially significant change to some key financial metrics such as gearing, meaning that some debt covenants could be affected (if not based on 'frozen GAAP'). Moreover, it could affect the cost of borrowing for some entities. Lessees that are financial institutions may also find that their regulatory capital is affected.

There will also be an impact on the numbers reported in profit or loss. The typical straight-line operating lease expense will be replaced with a depreciation charge on the lease asset and an interest expense on the lease liability. For an individual lease, this will typically lead to a higher total expense being recognised in the early years as, although the depreciation charge will normally be straight-line, the interest expense will be front-loaded with a higher interest payable charge in the early years when there is a bigger liability outstanding.

Perhaps less obviously, entities that currently have material off-balance sheet leases are also likely to report higher operating profits when compared to the amounts reported today. This is because a lessee will present the implicit interest in former off-balance sheet lease payments as part of finance costs whereas, today, the entire expense is included as part of operating costs. EBITDA will also increase, as both the interest cost and the depreciation charge will be excluded when calculating it whereas today no adjustment is made for the operating lease expense.

The change in lease accounting does not, of course, cause a change in total cash flows, excluding any tax implications, because there is no change to the economics. There may, however, be a change in how cash flows appear in the cash flow statement. Many entities currently classify cash outflows associated with operating leases as operating cash flows, meaning that the adoption of IFRS 16 will result in a reduction in amounts classified as operating cash outflows and a corresponding increase in amounts classified as financing cash outflows. However, some entities classify interest payable as an operating cash flow, in which case this component of the leasing cash flows would remain as an operating item.

APPENDIX 2

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see via http://www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax).