Tax Alert

IFRS 16 - Leases: Tax implications of this new leasing standard

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Get in touch

Francis Kamulegeya
Country Senior Partner
+256(0)312 354 400
francis.kamulegeya@pwc.com

Plaxeda Namirimu
Associate Director
+256(0)312 354 400
plaxeda.namirimu@pwc.com

Trevor Lukanga Bwanika
Senior Manager
+256(0)312 354 400
trevor.b.lukanga@pwc.com

Veronica Yvonne Magembe
Manager
+256(0)312 354 400
veronica.y.magembe@pwc.com

In brief

IFRS 16 on leases became effective 1 January 2019. Based on this new standard, accounting disclosures for operating leases have been impacted. IFRS 16 brings about significant changes to both the Income Statement and the Balance Sheet of the lessee. The corresponding tax implications for operating leases under the Income Tax Act, Cap 340 should be re-examined. The tax implications for lessors are substantially unchanged.

Section 59 of the Income Tax Act ("ITA") provides for the tax treatment of finance leases. For a lease to qualify as a finance lease under this section, consideration is given to its effective life, the option to purchase the property and the estimated residual life of the property. Based on this section, taxpayers are able to distinguish between finance and operating leases which results in different tax implications

In detail

Accounting treatment.

Introduction of IFRS 16

The International Accounting Standards Board issued IFRS 16 Leases (IFRS 16 or the new standard) in January 2016 with an effective implementation date of 1 January 2019.

IFRS 16 replaced the old standard, IAS 17. IFRS 16 was introduced to eliminate nearly all off balance sheet accounting for leases.

Impact of IFRS 16 on the right of use assets

Under the new standard, a contract is or contains a lease if it conveys the right of use assets (underlying asset) for a period of time in exchange for consideration.

Lessee

The new standard requires lessees to recognise leases on their balance sheet except for low value assets and short term leases.

The lessee is required to initially recognise a right of use asset (Dr) and a corresponding liability (Cr) at the present value of future lease payments in the balance sheet. Any lease payments made reduce the lease liability as well as the right of use asset.

A depreciation expense of the right of use asset and an interest charge on the outstanding lease liability is recognised in the income statement.

The above single accounting model no longer distinguishes between finance and operating leases from a lessee's perspective as was the case under IAS 17. This means leases that were previously classified by lessees as operating leases and therefore treated as off balance sheet rights or obligations may have to be recognised on the balance sheet if they meet the IFRS 16 criteria.

Lessor

The accounting for lessors remains substantially unchanged however, lessors now have new disclosure requirements.

Tax treatment

Finance lease

Section 59(3) of the ITA provides that a lease qualifies as a finance lease if any of the following conditions is met:

- The lease term exceeds seventy-five percent of the effective life of the lease property;
- The lessee has an option to purchase the property for a fixed or determinable price at the expiration of the lease; or

- The estimated residual value of the property to the lessor at the expiration of the lease term is less than twenty percent of its market value at the commencement of the lease.

A lessee was allowed to claim capital allowances in respect of a leased property as well as deduct the interest expense incurred on lease payments.

The lessor under this arrangement treated the interest income received from the lessee as part of its taxable income.

Operating lease

The lessee in this instance would be allowed to deduct the lease rental payments made to the lessor.

The lessor was allowed to claim capital allowances in respect of the leased property. The lease rental income received from the lessee formed part of its taxable income

Tax consequences after implementing IFRS 16

Finance lease

The tax law on treatment of finance leases remains the same. Section 59 of the ITA provides for tax consequences of a finance lease and these will continue to apply for finance leases. If the lease under IFRS 16 does not meet the definition for a finance lease under the ITA, then it is treated as an operating lease for tax purposes.

Operating lease

For operating leases, the lessee is not entitled to claim capital allowances since the lessor claims allowances in respect of the leased asset.

The interest expense in the income statement should be tax deductible. However, the depreciation charged for the right of use asset is not a tax-deductible expense.

The capital component of the periodic lease payment on the balance sheet in our view should be treated as a tax deductible cost given that from a tax perceptive the substance of the transaction does not change but only the accounting disclosure. URA may be of a different view regarding the tax deductibility of the capital component. Further engagements with the URA are encouraged to agree on this position.

The tax consequences for lessors remain un-changed, i.e. they claim capital allowances and lease rental income remains taxable.

Other leasing tax consequences

Examples of entities expected to be significantly impacted by the new standard include:

- Telecoms need to consider their contracts with tower companies, data and fixed line contracts;
- Retail and consumer product entities, such as supermarkets, restaurant chains, and filling stations need to consider their current contracts for space being occupied while fleet managers assess their customer contracts;
- Banks with wide branch networks and various ATM machines need to reassess their contracts;
- Tenants with contracts for lease of property and office space; and
- Mining, oil and gas entities that lease equipment as well as land and buildings.

In a recent Tax Appeals Tribunal Case of Vivo Energy Uganda Ltd Vs Uganda Revenue Authority, Court ruled that an expense incurred for the lease of land is not a revenue expense and accordingly is not tax deductible.

Takeaway

Taxpayers should reassess their existing contracts to determine whether they qualify as leases under IFRS 16. Once this is determined, correct tax accounting principles should be applied.