Draft for comments

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TAX IMPLICATIONS RELATED TO THE IMPLEMENTATION OF FRS 117: LEASES

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1. INTRODUCTION

1.1 BACKGROUND OF FRS117

1.1.1 Rationale

The Standard prescribes for lessors and lessees the appropriate accounting policies & disclosures to be applied in relation to leases.

The main objective of the Standard was a limited revision to clarify the classification of a lease of land and buildings and to eliminate varying accounting treatment of initial direct costs in the financial statements of lessors.

This paper will focus only on the above changes incorporated in the Standard.

1.1.2 Scope of FRS 117

The Standard is applied in accounting for all leases other than:

(a) leases to explore for or use minerals, oil, natural gas and similar non-generative resources; and

(b) licensing arrangements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights

However, it is stipulated that the Standard is not to be applied as a basis of measurement for:

(a) property held by lessees that is accounted for as an investment property (refer to FRS140 Investment Property)

(b) investment property provided by lessors under operating leases (refer to FRS140 Investment Property).

1.1.3 Definition of essential terms

The definitions used in the Standard include:

Lease - an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

Finance lease - a lease that transfers substantially all risks and rewards incidental to ownership of an asset. Titles may or may not eventually be transferred.

Operating lease - a lease other than a finance lease.

1.1.4 Effective date

FRS 117 is effective for annual periods beginning on or after 1 January 2006.

2. SCOPE OF COMMENTS

The paper will cover the main changes in the FRS regime affecting tax i.e. the classification of lease of land and buildings and the accounting treatment of initial direct costs in financial statements.

3. ACCOUNTING AND TAX TREATMENT BEFORE FRS 117 IMPLEMENTATION

Before the implementation of FRS 117, the accounting and the tax treatment of leasehold land and building and initial direct costs were as follows:

3.1. LEASEHOLD LAND AND BUILDING

The leasehold land and building were classified as one under property, plant and equipment (PPE) in the balance sheet. The cost of both the land and building was tracked in the notes to the accounts under PPE and depreciation was expensed off to the income statement. From the tax perspective, depreciation is non-tax deductible and any qualifying industrial building expenditure for tax purposes is eligible for industrial building allowance claim.

3.2 INITIAL DIRECT COSTS

The accounting and tax treatment in respect initial direct costs i.e. expenses incurred in negotiating and securing leasing arrangements are as follows:

3.2.1 Finance lease

For a lessor, from the accounting perspective, there is an option to either,

(i) charge as an expense as and when incurred; or

(ii) include as part of the carrying amount of the leased assets at inception of the lease (i.e. receivables) and recognise over the lease term.

In the case of manufacturer or dealer lessor, the accounting treatment is to recognise as an expense immediately at the commencement of the lease term because they are related to earning the manufacturer’s or dealer’s selling profit. For the tax treatment, since companies generally choose option (i) i.e. to charge expense to Profit and Loss Account, no tax adjustment is required. Tax deduction claim will be based on the amount charged out to the Profit and Loss Account.

For the lessee, in the accounts the expense is included as part of the amount recognised as an asset (i.e. not included in the leased liability for future lease payments).

From the tax perspective, for the lessee, if the arrangement is a 'deemed sale' under the Income Tax Leasing Regulations 1986 (ITLR), capital allowances can be claimed on qualifying assets based on principal repayment. Therefore, there is a need to identify initial direct costs separately in the first year and claim capital allowances (normally through a reconciliation difference between cost of fixed asset and finance lease liability). In a lease arrangement, initial direct costs are not deductible for new leases as these are considered initial expenses. For renewal of leases, however, the expenses are claimable as a deduction under section 33(1) of the Income Tax Act 1967(ITA).

3.2.2 Operating lease

The accounting treatment is not specifically provided in the Standards. The tax treatment for the lessor is to allow the expense charged out in the Profit and Loss Account. For the lessee, it will depend on whether it is an expense relating to a new lease or renewal of a lease. Generally initial direct costs are not deductible for new leases as these are initial expenses. However, for renewal of leases, the expenses are claimable as a deduction under section 33(1) of the ITA.

4. ACCOUNTING AND TAX TREATMENT AFTER IMPLEMENTATION OF FRS117

4.1 LEASEHOLD LAND AND BUILDING

The key change noted with regard to the lessee is that lease of land and building are now considered separately for purposes of lease classification. Leases of land and of building are classified as operating or finance lease in the same way as the lease of other assets.

Lease of land is generally classified as an "operating lease" because land normally has an indefinite economic life and, if the title is not expected to pass to the lessee by the end of the lease term, and hence, the lessee does not receive substantially all risks and rewards incidental to the ownership of the land. In such a case, the payments made in acquiring or entering a lease of leasehold land represents "prepaid lease payments" and are amortised over the lease term.

If the title passes then the leasehold land is recognised as a "finance lease" in the balance sheet and presented as a receivable at an amount equal to the net investment in the lease.

Lease of a building is classified as operating/finance lease depending on whether the lease transfers substantially the risks and rewards incidental to the ownership either to the lessor or lessee.

Examples

The following examples illustrate the changes in accounting treatment with the implementation of FRS 117 and the potential tax issues that may arise:

4.1.1 Situation 1 - Splitting leasehold property (30-year lease) into two elements

A new 30-year lease is entered into with the lessor on payment of a land premium. The lessee constructs a building on the site for its own use.

(i) Accounting treatment:

(a) Land premium is assumed to be fair value of the land and will be accounted for as an operating lease i.e. the land premium will be reflected as "prepaid lease rental" under non current assets and it is amortised over 30 years in the lessee's income statement.

(b) Building is classified as finance lease or operating lease depending on the economic life of building. If the building's economic life is less than 30 years it will be a finance lease but if it is longer than 30 years it will be classified as an operating lease.

(ii) Tax issues:

<u>Land</u>

(a) Cost of land is no longer reflected in PPE. It is disclosed separately from building cost as "prepaid lease payments" and disclosed under "non-current assets".

(b) Land - amortisation of 'prepaid lease rentals' charged to income statement is not deductible.

(c) Documentation required to track cost of land for purposes of computing RPGT / income tax on gain on disposal

<u>Building</u>

(a) Building is classified as operating or finance lease depending on the economic life of the building at the inception of the lease.

(b) If the building is classified as an operating lease, the amorisation of 'prepaid lease rentals' in the income statement is not deductible. On the other hand, if it is a finance lease, the amount of interest charged to the income statement is deductible whilst depreciation will be added back in the tax computation.

(c) For purposes of industrial building allowance (IBA) claims, the lessee will be eligible for IBA on qualifying building expenditure incurred whether or not it is an operating or finance lease.

(iii) Proposal/ Recommendations on tax treatment: No change is recommended.

4.1.2 Situation 2 - Splitting leasehold property (99-year lease) into two elements

A piece of land with a 99-year lease is purchased from the developer. The lessee constructs a building on the land for its own use.

(i) Accounting treatment

(a) Consideration paid for land will be accounted for as an operating lease (i.e. the land consideration amortised to income statement as 'prepaid lease payment' over the 99-year period).

(b) Building is classified as a finance lease since the economic life upon completion of construction of the building will be for less than 99 years. In the balance sheet, the building is reflected as a fixed asset and the future lease payments will be shown under liabilities. The depreciation of the building and the interest expense will be charged to the P&L.

(ii) Tax issues

<u>Land</u>

(a) Cost of land no longer reflected in PPE. It is disclosed separately from building cost as "prepaid lease payments" under "non-current assets".

(b) Amortisation of prepaid lease rental is charged to the income statement is not tax deductible.

(c) Documentation required to track the cost of land for purposes of computing RPGT / income tax on gain on disposal.

<u>Building</u>

Building is classified as a finance lease. For IBA claims, the lessee is eligible to claim IBA based on the qualifying expenditure incurred on an industrial building.

(iii) Proposal/ Recommendations on tax treatment: No change in tax treatment is recommended.

4.1.3 Situation 3 - Leasehold property classified as finance lease

An entity acquires a leasehold property with 25 years left to run on the lease and a right to renewal for a further 30 years.

(i) Accounting treatment

(a) Assuming that in the absence of recent transactions in comparable vacant sites, it may not be possible to reliably identify the fair value of the land and of the building. In such a case the whole lease would be classified as a finance lease under FRS 116, *Property, Plant and Equipment.*

(b) For the lessee, in the balance sheet, the building is reflected as a fixed asset and future lease payments will be shown under liabilities. The depreciation of the building and the interest expense will be charged to the Profit and Loss Account.

(c) For the lessor, the leases payments will be shown as receivables and interest income recognised in the Profit and Loss Account.

(ii) Tax issues

(a) There is no change from the pre-FRS regime. For IBA claim purposes the lessee will be eligible to claim.

(b) Documentation required to track the cost of land for purposes of computing RPGT / income tax on gain on disposal / IBA.

(iii) Proposal/ Recommendations to tax treatment: No change.

4.1.4 Situation 4 - Leasehold property classified as operating lease

An entity leases a building (and the underlying land) for 10 years. The remaining economic life of the building when the lease is entered into is 30 years.

(i) Accounting treatment

(a) Both land and building are classified as operating leases.

(b) The lease is for a period which is considerably less than the economic life of the building, therefore no separation is necessary.

(c) For the lessee land and building are disclosed under “prepaid lease payments” under non – current assets and amortised to the Profit and Loss Account as “prepaid lease payments”.

(d) For the lessor, land and building will be disclosed as fixed assets under PPE and as “prepaid lease rental received” under liabilities. In the Profit and Loss Account, the "lease rental" will be accrued 10 years (lease term) and the carrying amount in the fixed asset will be depreciated over 30 years.

(ii) Tax issues

(a) Both the cost of the land and building are no longer reflected in PPE.

(b) For the lessee, amortisation of 'prepaid lease rentals' charged to income statement is not tax deductible.

(c) For the lessor, "lease rental" accrued is capital in nature as it is an accrual of the upfront payment received for the lease.

(d) For purposes of IBA claims, since the lessee has incurred payment for the building and if it is in use as an industrial building, the lessee should be entitled to the IBA. Hence, although the lessor is still the owner of the asset, the lessor is not eligible for IBA.

(e) There is no change in the tax treatment accorded to leasehold building under the pre FRS regime.

(f) Documentation required to track the cost of land for purposes of computing RPGT / income tax on gain on disposal / IBA.

(iii) Proposal/ Recommendations on tax treatment: No change

4.1.5 Leasehold property – transitional provisions

Prior to FRS 117, existing leasehold land and building were disclosed in PPE. With the implementation of the Standard, a restatement of financial statements is required in respect of the following:

(i) Unamortised carrying amount of leasehold land - to reclassify from PPE to "prepaid lease rentals" under "non-current assets". There are no tax implications.

(ii) Depreciation of land - to reclassify to amortisation of "prepaid lease rentals" (expensed off to income statement). For tax purposes, the expense is non-deductible.

(iii) Cost of land no longer reflected in the balance sheet, hence documentation is required to keep track of cost for RPGT / income tax on gain on disposal

There are no proposals or recommendations on the tax treatment.

4.2 INITIAL DIRECT COST

Initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease. The interest rate implicit in the lease has been amended to take into account initial direct costs of the lessor.

Examples of indirect costs are commission, legal fees & internal costs that are incremental and directly attributable to negotiating and arranging for a lease. The costs, however, exclude general overheads e.g. those incurred by a sales or marketing team.

The Standard does not permit initial direct costs of lessor to be charged as expenses incurred.

The key changes to the accounting treatment are as follows:

4.2.1 Finance lease

For the lessor, the accounting treatment is to include in the initial measurement of finance lease receivables and thus reduces the amount of income recognised over the lease term. The expense is also used in the calculation of the implicit interest rate. For manufacturer or dealer lessor, the expense is recognised when the selling profit is recognised (i.e. normally at the commencement of the lease term). It is no longer added to lease receivables.

In the case of the lessee, in the accounts the amount is added to the carrying amount of the asset (i.e. not included in the leased liability for future lease payments).

4.2.2 Operating lease

The accounting treatment for the lessor is for the amount to be added to the carrying amount of the leased asset and charged out as an expense on a straight-line basis over the lease term on the same basis as the lease income, regardless of the depreciation basis.

For the lessee the accounting treatment for the amount is to be added to the carrying amount of the leased liability (excluding costs for services such as insurance and maintenance) and recognised as an expense over the lease term.

Examples

The following examples illustrate the changes in accounting treatment and the tax treatment as a result of the implementation of the Standard.

Situation 1 - Finance lease

A new lease agreement is entered to lease out plant and machinery costing RM100,000 for a 10-year period. In negotiating the lease arrangement, the initial direct costs incurred by lessor and lessee are RM10,000 and RM5,000 respectively.

A. Lessor

(i) Accounting treatment

The initial direct costs of RM10,000 is recognised as an asset and thus is netted off against finance lease receivable. This amount is not specifically identified in the accounts. The effect of this treatment is that RM10,000 is recognised in Profit and Loss Accounts (i.e. by way of reduction in interest income receivable) over the lease term.

(ii) Tax treatment based on existing law

(a) Initial direct costs qualify for tax deduction under section 33(1)
(b) If tax deduction on RM10,000 is to be claimed on incurred basis, taxpayer needs to maintain separate records for tax purposes for the purpose of identifying :-
- the amount of initial direct costs
- the amount of amortisation to Profit and Loss Accounts on yearly basis and to add back the amount (since tax deduction has been claimed upfront).

(iii) Proposal/ Recommendations on tax treatment

For the lessor, initial direct costs are deductible under section 33(1) of the Income Tax Act 1967. However, in view of the accounting treatment above i.e. the amount of the costs are not readily identifiable, separate records must be kept for tax purposes so that tax deduction can be claimed when the expense is incurred. Further, by making a claim for deduction upfront as permitted under section 33(1), the lessor will need identify the exact amount amortised in the Profits and Loss Account each year and to add back the amount. Considering the amounts involved are generally small this approach is a time-consuming and cumbersome way of ensuring the correct taxes are computed.

The alternative, for purposes of expediency, is to converge tax and accounting treatment so that the amount amortised to the Profit and Loss Account on a yearly basis is allowed as a deduction. It is after all a timing issue.

B. Lessee

(i) Accounting treatment

The initial direct costs of RM5,000 is added to the carrying amount of the asset (but not included in the finance lease liability)

(ii) Tax treatment based on existing law

Initial direct costs as part of from the carrying amount of asset would qualify for capital allowances.

(iii) Proposal/ Recommendations on tax treatment

Under the current tax legislation, if the asset is a qualifying asset for purposes of capital allowances, initial direct costs would qualify as part of the qualifying expenditure of the asset.

In view of the above, since the initial direct costs are added to the carrying amount of the asset, tax treatment would be in convergence with the accounting treatment.

Hence, no change is proposed.

Situation 2 - Operating lease

Facts are the same as Situation 1:

A. Lessor

(i) Accounting treatment

The initial direct costs of RM10,000 is added to the carrying amount of the leased asset and recognized as an expense over the lease term on the same basis as the lease income.

(ii) Tax treatment based on existing law

(a) Initial direct costs qualify for tax deduction under section 33(1).

(b) If tax deduction on RM10,000 is to be claimed on incurred basis, taxpayer would need to maintain separate records for tax purposes for the purpose of identifying :-
- the amount of initial direct costs
- the amount of amortisation to Profit and Loss Accounts on yearly basis and to add back the amount (since tax deduction has been claimed upfront).

(iii) Proposal/ Recommendations on tax treatment

For the lessor, initial direct costs are deductible under section 33(1) of the Income Tax Act 1967. However, in view of the accounting treatment above, the amount of the costs are not readily identifiable, separate records must be kept for tax purposes so that tax deduction can be claimed when the expense is incurred. Also applying this tax treatment will require,to painstakingly identify the exact amount amortised in the Profit and Loss Accounts yearly and to add back the amount as it has already been claimed upfront. Considering the amounts involved are small this approach is a time-consuming and cumbersome way of ensuring the correct taxes are computed.

The alternative for purposes of expediency, is to converge tax and accounting treatment and claim the amortised amount in the P&L as the claim for deduction is only a timing issue.

B. Lessee

(i) Accounting treatment

The initial direct costs of RM5,000 is added to the carrying amount of the leased liability and recognised as an expense over the lease term

(ii) Tax treatment based on existing law

(a) Initial direct costs generally do not qualify for a deduction under section 33(1) of ITA unless it is incurred for the renewal of a lease.

(b) If tax deduction on RM 5,000 is to be claimed on incurred basis, taxpayer would need to maintain separate records for tax purposes for the purpose of identifying :-
- the amount of initial direct costs
- the amount of amortisation to Profit and Loss Accounts on yearly basis and to add back the amount (since tax deduction has been claimed upfront)

(iii) Proposal/ Recommendations on tax treatment

Initial direct costs generally do not qualify for tax deduction under section 33(1) ITA, except if the initial direct costs that are incurred on the renewal of a lease.

In view the accounting treatment the exact amount of the costs are not a readily identifiable and hence separate records need to be kept for tax purposes so that tax deduction can be claimed upfront i.e. in the year the full expense is incurred. Further applying the tax treatment under the legislation will require to painstakingly identify the amount of the expense amortised in the Profit and Loss Accounts over the term of the lease and to add back the amount since the amount has already been claimed upfront. Considering the amounts involved are generally small, applying this tax treatment is a time-consuming and cumbersome way of ensuring the correct taxes are computed.

The alternative approach for purposes of expediency, is to converge the tax and accounting treatment as the claim for a deduction is a mere timing issue in the case of renewal of leases where is it an allowable deduction.

5. INTERNATIONAL TAX PRACTICES

We have checked for guidelines on the tax treatment following the adoption of FRS 117 in UK, Singapore, Hong Kong and Australia and note that there were no guidelines issued to date.