FRS 116 Leases

Key Concepts of FRS 116 And Their Tax Implications

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Facilitated by:
Accredited Tax Advisor (Income Tax) Mr Chai Wai Fook and Mr Ronald Wong

FRS 116, the new accounting standard for leases, has confounded many professionals and companies. Sweeping changes to lessee accounting have moved leases onto lessees' balance sheets, while income statements are affected by the front-loading of expenses.

Recognising the challenges brought about by the new accounting standard, the Singapore Institute of Accredited Tax Professionals (SIATP) organised a *Tax Excellence Decoded* session where Accredited Tax Advisor (Income Tax) Chai Wai Fook, Partner, Tax Services, Ernst & Young Solutions LLP and Ronald Wong, Partner, Financial Accounting Advisory Services, Ernst & Young LLP, highlighted key concepts of the new accounting standard and their tax implications.

FRS 116 Lease Accounting Changes

There is good news for lessors – lessor accounting is substantially unchanged from current accounting.

Lessees, on the other hand, bear the brunt of the changes as most leases will now be recognised on their balance sheets as a right-of-use (ROU) asset with a related lease liability. Importantly, companies will need to focus on whether an arrangement contains a lease or a service agreement because there are significant differences in the accounting. Judgement may be required in applying the definition of a lease to certain arrangements, particularly those that include significant services.

Both lessees and lessors will be subject to additional and enhanced disclosure requirements.

DETERMINING IF AN ARRANGEMENT CONSTITUTES A LEASE

For an arrangement to constitute a lease under the new FRS 116, it is critical to consider if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

To assess whether a contract conveys the right to control the use of an identified asset for a period of time, companies will need to assess whether, throughout the period of use, the customer has both the right to obtain substantially all of the economic benefits from use of the identified asset and the right to direct the use of the identified asset. In contracts that include significant services, determining whether the contract conveys the right to direct the use of an identified asset will require judgement and may pose challenges to companies.

Accredited Tax Advisor (Income Tax) Chai Wai Fook, Tax Services Partner, Ernst & Young Solutions LLP, sheds light on the tax treatment and implications on leases of FRS 116.

Lease and non-lease components

Within a contract, lease and non-lease components are required to be accounted separately, unless companies apply the practical expedient to combine both components. Election applies to the entire class of underlying assets. The consideration is then allocated based on each component's relative standalone selling price (if the price is not readily available, an estimate should be used by maximising observable inputs).

Identifying non-lease components of contracts may change practice for some lessees and more robust processes will need to be put in place to identify the lease and non-lease components of contracts.

Short-term leases and low-value asset leases

Short-term leases and leases for which the underlying asset is of low value may be exempted from applying a single lessee accounting model under FRS 116.

A lease is considered short term if the term is 12 months or less, without purchase options. When determining the period, extension options must be factored in if it is reasonably certain that they would be exercised.

Leases are assessed on an asset-by-asset basis when determining if the "low-value asset" criterion is met, but only when each asset is not highly dependent on or interrelated with others. For example, the leasing of tyres separately from a truck may not constitute a low-value asset lease as they can only be used with the truck and as such, they are dependent on, or highly interrelated with the truck. Contrast this to the leasing of 200 laptops where each laptop could potentially qualify as low-value asset given each laptop may be assessed as being distinct on its own. As to the definition of "low value", the International Accounting Standards Board has in mind a value of US$5,000 or less, based on when the asset is new.

Lease liability measurement for lessees

As mentioned earlier, lessees would now recognise an ROU asset and a lease liability on their balance sheet under FRS 116.

The lease liability is the present value of remaining lease payments at commencement. "Lease payments" refer to fixed payments (and in-substance fixed payments), variable lease payments based on an index or rate (but not those based on performance or usage), lease incentives and residual value guarantees. Lease payments are also required to include termination penalties and the exercise price of purchase options if they are reasonably certain to be incurred or exercised.

Ideally, the discount rate to be used in the present value calculation would be the interest rate implicit in the lease, but this could be difficult to obtain in practice. Incremental borrowing rate, which is the rate that the lessee would incur in borrowing (over a similar term and with a similar security) the funds necessary to obtain an asset of a similar value to the ROU asset in a similar economic environment, is often used as an alternative.

Tax Treatment For Leases

The Inland Revenue Authority of Singapore has issued an e-Tax guide on 8 October 2018 to provide guidance on the tax treatment for entities adopting FRS 116 or SFRS(I) 16.

Tax treatment for lessor

There is no change to the existing tax treatment for lessors as lessor accounting has remained substantially the same under FRS 116. The tax treatment depends on the classification of the lease under section 10D of the Income Tax Act (ITA).

For leases classified as operating lease for tax purposes, the lessor is taxed on the lease income on an accrual basis. Capital allowance is claimable by the lessor on the leased asset if it qualifies as a machinery or plant. Lessors can continue to elect to be taxed on their lease income determined using the effective rent method under FRS 116, on the condition that the application of FRS 116 tax treatment is made consistently every year and across for all operating leases.

For finance leases not treated as a sale agreement for tax purposes, the full lease payment (both interest and principal repayment) is taxable. Capital allowance can be claimed on the leased asset (if it qualifies as a machinery or plant), but only against finance lease income. This restriction for capital allowance is lifted when the lessor stops carrying on finance lease activities.

For finance leases treated as a sale agreement for tax purposes, the lessor is taxed on the interest income on an accrual basis. Principal repayment is not taxable. Capital allowance is not allowed on the leased asset for the lessor.

Tax treatment for lessee

Notwithstanding the change to a single lessee accounting model, lessees would be allowed to claim tax deductions based on the contractual lease payments incurred, except under circumstances when a sale is regarded to have taken place for tax purposes. On the other hand, interest expense and depreciation charged to the profit or loss account would have to be added back in the tax computation.

Where a lease arrangement giving rise to an ROU asset meets the statutory definition of a finance lease under Section 10D(3) of the ITA and is regarded to be a sale agreement, the lessee would be eligible to claim interest expense and capital allowances, but not the lease payment. A lease arrangement that does not meet the definition of a finance lease under Section 10D(3) of the ITA will be regarded as an operating lease.

To determine whether a finance lease should be regarded for tax purposes as a sale agreement, reference should be made to the conditions listed in paragraphs (a) to (e) of Regulation 4(1) of the Section 10D (Income from Finance Leases) Regulations. If any of these conditions is satisfied, then the finance lease is treated as a sale agreement.

Transitional tax treatment

For lessors, tax adjustments are generally unnecessary since tax treatment remains unchanged. Although intermediate lessors (under subleases) must reassess their classification of subleases under FRS 116, no tax adjustment is required.

Lessees can continue to deduct contractual lease payments for tax purposes, except where the lease is a finance lease regarded as a sale. Any accounting adjustments to beginning retained earnings are neither taxable nor deductible.

Sublease Arrangements Under FRS 116

Notwithstanding the accounting treatment for sublease under FRS 116, for tax purposes, the classification of a sublease for the intermediate lessor is to be determined by reference to the underlying asset instead of the ROU asset. The tax treatment for the intermediate lessor will depend on the classification of the sublease for tax purposes.


Accredited Tax Advisor (Income Tax) Chai Wai Fook (2nd from left) and Ronald Wong (2nd from right) answered queries about FRS 116 and its tax treatment.

Withholding Tax

Withholding tax obligations are based on the legal characterisation of the payment (lease or interest) as provided in the ITA, regardless of the accounting classification of the expenses in the profit or loss account.

The lessee will have to treat the entire amount of lease payments to a non-resident lessor under an operating lease or finance lease not regarded as a sale for the use of any movable property as rental payment for withholding tax purposes and withhold tax, unless specific exemption applies. On the other hand, the lessee will have to withhold tax on the interest portion of the lease payments to a non-resident lessor under a finance lease treated as a sale agreement unless specific exemption applies. As an administrative concession, tax may be withheld based on interest expense as recognised by the lessee (that is, computed with the lessee's own incremental borrowing rate).

To navigate the many changes to lease accounting and the resulting tax implications, taxpayers would need to pay close attention to the differences between the accounting and tax treatment, for example, the need to recharacterise lease payments for withholding tax compliance. Taxpayers should also expect increased scrutiny from the tax authorities going forward, and start preparing documentation to substantiate their tax positions and lease classification for tax purposes.

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Facilitators

Mr Chai Wai Fook
Partner, Tax Services
Ernst & Young Solutions LLP
Accredited Tax Advisor (Income Tax)
T: +65 6309 8775
E: wai-fook.chai@sg.ey.com

Mr Ronald Wong
Partner, Financial Accounting Advisory Services
Ernst & Young LLP
T: + 65 6309 6155
E: ronald.wong@sg.ey.com

Felix Wong is Head of Tax, SIATP. This article is based on SIATP's Tax Excellence Decoded session facilitated by Accredited Tax Advisor (Income Tax) Chai Wai Fook, Partner, Tax Services and Ronald Wong, Partner, Financial Accounting Advisory Services, Ernst & Young.

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