New lease accounting standard: Tax matters for lessees

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In brief

New accounting standard, *AASB 16 Leases* makes significant changes to the way leases are accounted for in the financial statements. The changes predominantly affect lessees with almost all leases, including new and pre-existing operating leases, to be brought onto the balance sheet for annual reporting periods commencing from 1 January 2019. The distinction that previously existed between finance leases (on balance sheet) and operating leases (off balance sheet) has been removed for lessees.

Not only is it important for lessees to determine the impact in the financial reports of this new accounting standard, it is also critical to assess the associated tax consequences of the accounting change both on a transition and ongoing basis. Some of the key tax issues that lessees should consider include:

- potential transfer pricing consequences resulting from changes to financial ratios
- increased complexity and data requirements when preparing tax return and deferred tax calculations
- the recognition of additional assets and liabilities that may impact on the taxpayer's thin capitalisation position and tax cash outcomes for taxpayers, and
- the recognition of additional lease liabilities that may impact on tax consolidation entry and exit outcomes.

In detail

Subject to some exceptions for short term and low value leases, AASB 16 requires lessees to recognise all operating leases, including real estate leases, on balance sheet for all annual reporting periods beginning on or after 1 January 2019. This means that lessees will recognise a lease liability (reflecting the obligation to make future lease payments) and a lease asset (representing the right to use the underlying leased asset). Interest expense on the lease liability and depreciation on the right-of-use asset will be reported in the income statement as opposed to the operating lease expense that has been historically recognised. As a result, key financial metrics and financial ratios (e.g. gearing ratios) will also be impacted. Our publications *IFRS 16: The leases standard is changing* and *IFRS 16 Leases: Managing the impact on your financing arrangements* provide further analysis of the key accounting and commercial considerations.

The accounting change raises a number of tax consequences including transfer pricing, tax compliance, and outcomes relevant for thin capitalisation and tax consolidation purposes which are discussed in detail below.

Transfer pricing considerations

Because the change in accounting for lease payments will have a direct impact on the lessee's financial metrics such as earnings before interest, taxes, depreciation and amortization (EBITDA) - which will increase as the operating lease expense is replaced with interest and depreciation expense - and EBIT, there may be a flow-on effect on the pricing of certain cross-border transactions which will also have a potential transfer pricing implication.

Specifically, taxpayers who adopt transfer pricing policies which are based on a targeted EBIT or EBITDA ratio will need to consider the impact of these changes on their position. The changes could impact both the taxpayer itself and independent comparable companies that may be relied upon as arm's length benchmarks. There will likely be a time lag before the impact on independent comparables begins to flow through into transfer pricing benchmarking studies, so the immediate consideration will be on the impact to the taxpayer. If this is expected to be material, taxpayers may need to consider whether any modifications are required to their transfer pricing policies and/or their approach for testing whether the outcomes of their transfer pricing arrangements are arm's length.

For taxpayers who have entered into advance pricing arrangements (APAs) which agree upon certain profit ratios with the Australian Taxation Office (ATO) (and another tax authority if the APA is bilateral), it may be necessary to consider whether the changes could breach any critical assumption and whether engagement with the ATO is required to agree to an approach for addressing the impacts of the changes on the APA.

Tax compliance - increased complexity and data requirements

While the new accounting standard does not affect the way in which Australian tax law deals with leasing arrangements, the fundamental differences between the tax and accounting treatment of operating leases going forward will give rise to new temporary differences and book to tax adjustments. Although taxpayers may already be familiar with the deferred tax and tax compliance consequences of finance leases under the previous accounting standard, the extent and complexity will significantly increases once operating leases (including pre-existing leases) and finance leases are treated in the same way under the new accounting standard.

Tax departments need to work closely with the finance team to ensure they have access to systems and data to capture the required information for tax return and deferred tax calculations. For example, following adoption of the new standard, it will be necessary to identify the portion of interest expense in the financial statements that relates to all lease liabilities as opposed to interest on other financing instruments. For those lessees with significant volumes of operating leases, the ability to readily extract accurate data from the relevant systems is of critical importance.

Application of deferred tax accounting to lease assets and liabilities does have some complications and uncertainties, particularly in relation to appropriate treatment upon their initial recognition. Understanding the basis on which deferred tax balances are calculated and proved will be important.

Thin capitalisation - impact on safe harbour debt amount and arm's length debt test calculations

Recognition of additional accounting assets and non-debt liabilities (i.e. lease liabilities) may have transitional and ongoing impacts on thin capitalisation outcomes for those taxpayers using the safe harbour method.

On first adoption of the new standard, there are various transitional methods available for recognising pre-existing operating leases on the balance sheet. The relative values of the right-of-use asset and the lease liability recognised on the date of transition differ under each transitional method. Accordingly, taxpayers need to be aware that the transitional method chosen will determine the immediate impact on the taxpayer's thin capitalisation position and resulting tax cash outcomes.

In respect of new leases, while the lease liability and asset may in many cases be recognised at a similar value at commencement of the lease, the relative values will generally diverge over the lease term. In simple terms, where the carrying amount of the right-of-use asset is valued at an amount less than the lease liability, this can reduce the safe harbour debt amount and potentially have an adverse impact on the ability of the taxpayer to claim debt deductions.

Taxpayers who rely upon the arm's length debt test may also need to consider the impact on their position. It is common for financial ratios such as Debt/EBITDA and EBITDA/Interest to be considered as part of the analysis to estimate the maximum arm's length amount of debt under the "independent lender test". On the face of it, a higher EBITDA outcome could have a favourable impact, however, since these ratios are typically used by lenders as a proxy for cash flows, and actual cash flows will not change, further consideration would need to be given as to the impact this would have in an arm's length situation.

Tax consolidation - impact on entry and exit outcomes

Taxpayers engaging in mergers and acquisitions or restructures need to be aware that the recognition of additional lease liabilities on balance sheet may result in distorted tax cost setting outcomes on entry to a consolidated group as well as potentially impacting the tax outcomes on exit. In the absence of an amendment to the law to expand the modifications that currently apply for finance leases to *all* leases recognised on the balance sheet, tax consolidation entry and exit calculations may have different outcomes to those that applied before adoption of the new accounting standard.

The takeaway

As accounting teams start working through the transition to the new leasing standard, it will be important that tax is represented during the implementation process. To make the transition to the new accounting standard as smooth as possible, tax and finance teams should work closely together. This is not only necessary to identify any changes to systems that may be necessary to ensure information required for tax compliance and deferred tax calculations is readily available, but also to consider the tax consequences which can emerge from the options available under the accounting standard to transition pre-existing leases.

For those taxpayers subject to thin capitalisation or transfer pricing, the impact of the accounting changes should be considered as soon as possible, preferably before the start of the first applicable year in which AASB 16 is applied.

Let’s talk

For a deeper discussion of how these issues might affect your business, please contact:

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