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Leasing: NZ IFRS 16

1. Thank you for your letter of 3 October 2018 inviting the New Zealand Law Society (Law Society) to comment on the proposed tax treatment of leasing income and expenditure, following the adoption of New Zealand International Financial Reporting Standards (IFRS) 16.¹
2. The letter sets out proposed amendments in relation to the tax treatment of leasing which, subject to government approval, could be included in a tax bill to be introduced in 2019.
3. The Law Society agrees that the adoption of NZ IFRS 16 presents a good opportunity to simplify the taxation of leases. However, the Law Society considers that aspects of the proposals will be counter-productive and may adversely impact some taxpayers, as discussed below.

Proposed adjustments to NZ IFRS 16 undermine aim to simplify tax compliance

4. We understand one of the key aims of the proposals is to simplify tax compliance for lessors and lessees by aligning, as closely as possible, the tax treatment of leases with their accounting treatment.
5. The Law Society supports the aim of simplifying the tax treatment of leases through a closer alignment with accounting but is concerned that the proposed alignment is not sufficiently close. In particular, the proposed exceptions to NZ IFRS 16 treatment for (amongst other things):
 - (a) impairments, fair valuing, and revaluations of “right of use” assets; and
 - (b) estimated rehabilitation/make good costs;

will require taxpayers to maintain separate tax registers to track these adjustments. Anecdotal feedback from lessors indicates these adjustments will require a significant amount of time to process. It is not clear that adopting NZ IFRS 16 with these exceptions will be any easier than applying the current rules.

¹ <https://www.ifrs.org/issued-standards/list-of-standards/ifrs-16-leases/>.

6. The Law Society appreciates that Inland Revenue is concerned that adopting NZ IFRS 16 in full for tax could result in accelerated deductions, e.g. for estimated rehabilitation or make good costs.
7. However:
 - (a) Any tax advantages for taxpayers would be timing advantages only;
 - (b) It is not always the case that deductions would be accelerated. As acknowledged in the letter, deductions for certain expenses that are currently claimed upfront may be deferred if NZ IFRS 16 were adopted in full, because they would be capitalised to the cost of the lease; and
 - (c) There are accounting and commercial drivers that should operate to discourage taxpayers from acting aggressively in this area. For example, balance sheet considerations should discourage taxpayers from overstating their lease liabilities to accelerate tax deductions.
8. In the Law Society's view, a closer alignment with NZ IFRS 16 could be implemented to help truly simplify the rules, without jeopardising the tax base. This is an area on which officials should focus when drafting the rules. We consider that a reasonable approach in the circumstances would be to allow taxpayers to calculate their lease expenditure under NZ IFRS 16 with:
 - (a) An optional adjustment for estimated rehabilitation or make good costs. If a taxpayer does not adjust for such costs, any difference between the amount claimed and the ultimate actual costs would be dealt with under a wash-up on expiry or termination of the lease; and
 - (b) An optional adjustment for incurred direct costs. Taxpayers should be able to treat direct costs separately from the leased asset, if they wish to do so.

The proposals could adversely affect some taxpayers

9. The letter says that Inland Revenue does not intend to change the tax definitions of finance and operating leases or their fundamental tax treatment, but aspects of the proposals could have significant adverse tax effects for some taxpayers. We set out examples below.

Treatment of tax operating leases as depreciable assets

10. The proposal that "[right of use] assets from tax operating leases could, except for the depreciation rate, be treated as if they were depreciable plant" would represent a fundamental change from the current tax settings.
 - (a) Under the current rules a lessee is not generally subject to tax on consideration they receive for assigning an operating lease, except in certain narrow cases (e.g. section CC 1B).
 - (b) If tax operating leases were treated as depreciable property, then the consideration a lessee receives for assigning a lease may be subject to tax under the depreciation recovery rules. This tax would not arise under the current rules.
11. In the Law Society's view, the application of accounting standards to tax operating leases:

- (a) should be restricted to the quantification of income / expenditure only; and
- (b) should not alter the fundamental treatment of the lease for tax (see the depreciation point above).

Treatment of sale and leaseback transactions

12. Inland Revenue proposes that the tax finance lease rules should apply for real property and chattels in sale lease back transactions that are accounted for as financing transactions. This is justified on the basis that:
- (a) finance lease treatment would be more straight forward from a tax compliance point of view for mixed sale and lease backs of real property and chattels; and
 - (b) “These transactions are commercial funding transactions for both parties and the accounting reflects this. In these circumstances it seems more appropriate to treat all leases as finance leases for tax, even if they do not meet the current finance lease criteria”.
13. In the Law Society’s view, neither of these reasons is compelling enough to justify mandatory finance lease treatment given the significant and potentially adverse tax consequences, which could include:
- (a) altered timing and recognition of expenditure,
 - (b) potential depreciation recovery income issues, and
 - (c) potential withholding tax issues.

At best, the rationale identified in the letter supports an elective treatment of operating leases under sale and lease back arrangements as finance leases.

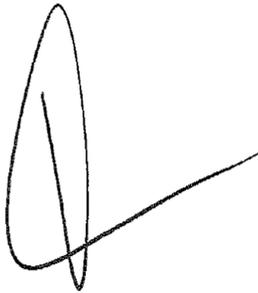
Broad transitional rules required

14. In the letter officials (at paragraph 64) (emphasis added):
- “suggest all taxpayers should be allowed **a one-off choice to adopt any changes made**, for example to follow the lease accounting for tax operating leases if enacted”
- It is not altogether clear what is being suggested. Is it intended that taxpayers will be able to choose whether or not to apply the new rules to existing and future leases they enter into?
15. In the Law Society’s view a broad election that applies to both current and future lease arrangements is preferable to a grandfathering approach allowing only existing leases to continue to be taxed under the current rules. A broad election would be in keeping with the objectives of the proposals to:
- (a) simplify the taxation of leases – it may be easier for taxpayers to continue to apply the existing rules, so they should be allowed to do so if they choose;
 - (b) broadly maintain the current tax treatment of leases – given some taxpayers may be adversely impacted by the new rules, they should be allowed to maintain the current tax treatment if they choose.

Other comments

16. The Law Society supports the intention to generally preserve the withholding tax and GST treatment of leases. Reinforcing our comments above, if there are any changes to the withholding tax or GST treatment of leases, these changes should apply by election only.
17. A 2019 application date for the new rules would be very optimistic given the issues that need to be worked through. In the Law Society's view, any new rules should not take effect until the 2021-22 income year so that there is adequate time to formulate appropriate rules.
18. We hope you find these comments helpful. If you have any questions or wish to discuss the comments, I can be contacted via the Law Society's Law Reform Adviser, Emily Sutton (Emily.Sutton@lawsociety.org.nz / 04 463 2978).

Yours faithfully

A handwritten signature in black ink, consisting of a large, stylized loop followed by a horizontal stroke extending to the right.

Andrew Logan
Vice President