Technical Accounting Alert

TA 2019-09

Proposed amendments to accounting for deferred tax on leases and the current position

Introduction

On 25 July 2019, the AASB published for public comment proposed changes to AASB 112 *Income Taxes* as Exposure Draft ED 294 *Deferred Tax related to Assets and Liabilities arising from a Single Transaction*, with comments to be received by 18 October 2019. This is equivalent to ED/2019/5 published by the International Accounting Standards Board (IASB) on 17 July 2019 (amending IAS 12 *Income Taxes*), with comments to be received by 14 November 2019.

Background

Currently, AASB 112 includes exceptions (called 'exemptions' in the standard) to recognising deferred tax liabilities and assets relating to temporary differences arising on initial recognition of an asset or liability in a transaction that:

(a) is not a business combination; and
(b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

There has been some uncertainty in the market about whether the exemption applies to leases and decommissioning obligations resulting in diversity in practice. This is not a new issue and is relevant to existing finance leases for lessees under AASB 117 *Leases* and decommissioning obligations, including lease make good obligations. However, with most existing operating leases coming 'on balance sheet' for lessees for reporting periods beginning on or after 1 January 2019, the issue is now significant to many more entities.

In some circumstances, an entity accounts for transactions by recognising both an asset and liability. For example, a lessee recognises a right-of-use asset and a lease liability at the commencement date of a lease under AASB 16 *Leases*. Such transactions may give rise to equal and offsetting temporary differences, which would result in the recognition of deferred tax assets and liabilities under the general principle in AASB 112. However, the recognition exemption in AASB 112 may prevent the entity from recognising such deferred tax.

The IFRS Interpretations Committee (Committee) observed that views differ on whether the recognition exemption applies to temporary differences that might arise from such a transaction. The Committee recommended that the IASB amend IAS 12 to narrow the application of the recognition exemption so that it would not apply to such transactions. The IASB agreed with the Committee's recommendation and published the ED to align the accounting for the tax effects of particular transactions with the general principle in IAS 12 of recognising deferred tax for all temporary differences.

How do the existing requirements apply to leases?

AASB 16 requires a company to recognise a right-of-use asset and a lease liability for leases. Over the lease term, the company recognises depreciation and interest expense as it uses the lease asset and settles the lease liability. However, many tax authorities (including in Australia) provide tax deductions only when a company makes lease payments. In these circumstances, a company needs to apply judgement in determining whether those tax deductions relate to the lease asset (because they relate to expenses from the lease - depreciation and interest expense) or to the lease liability (because they relate to the repayment of the lease liability and interest expense).

When tax deductions relate to the lease asset, no temporary differences arise when a company initially recognises the lease asset and lease liability. When tax deductions relate to the lease liability, temporary differences arise on initial recognition. However, AASB 112 prohibits a company from recognising deferred tax for such temporary differences if the recognition exemption applies.

The IASB are aware that views differ on whether the recognition exemption applies to temporary differences arising when a company initially recognises a lease.

When a company does not recognise deferred tax, the tax expense for all periods during the lease term will reflect tax deductions as and when they become available for tax purposes (that is, when lease payments are made), rather than as the company uses the lease asset and settles the lease liability.

What are the proposed amendments?

The proposed amendments would require an entity to recognise deferred tax for temporary differences on such transactions where an entity recognises both an asset and a liability, such as leases and decommissioning obligations and tax deductions relate to the liability, but only to the extent that at the time of the transaction the initial recognition gives rise to equal amounts of both taxable and deductible temporary differences.

Where equal amounts of taxable and deductible temporary differences arise in such a situation, an entity would recognise:

(a) a deferred tax asset for the deductible temporary difference to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised;

(b) a deferred tax liability for the taxable temporary difference. However, the amount of the deferred tax liability shall not exceed the amount of the deferred tax asset recognised for the associated deductible temporary difference (proposed new paragraph 22A).

In the following paragraphs, we have considered some potential circumstances which may occur in practice.

Advance lease payments and initial direct costs

At the commencement date of a new lease under AASB 16, making prepaid lease payments or paying initial direct costs could cause the initial value of the right-to use asset to exceed the lease liability and thus result in additional taxable temporary differences associated with the lease asset.

The proposed amendments do not affect these differences because they do not give rise to equal and offsetting temporary differences. Therefore, an entity would apply the existing requirements in AASB 112 and would be likely to recognise a deferred tax liability for these differences. The initial recognition exemption will not apply to these differences because the amounts are likely to be deductible for tax purposes when paid. The proposed amendments would still apply to equal and offsetting differences arising from the lease liability and the related component of the right-to use asset.

Lease incentives received in cash at lease commencement

At the commencement date of a new lease under AASB 16, receiving a lease incentive in cash could cause the initial value of the right-to use asset to be lower than the lease liability and thus result in an additional deductible temporary difference associated with the lease liability.

The proposed amendments do not affect this difference because it does not give rise to equal and offsetting temporary differences. Therefore, an entity would apply the existing requirements in AASB 112 and would be likely to recognise a deferred tax asset for this difference. The initial recognition exemption will not apply to this difference because the lease incentive is likely to be taxable when received. The proposed amendments would still apply to equal and offsetting differences arising from the right-to-use asset and the related component of the lease liability.

Lease make good obligations

At the commencement date of a new lease under AASB 16, a make good obligation is recognised as a provision under AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* and could cause the initial value of the right-to use asset to exceed the lease liability.

The proposed amendments do apply because the initial recognition of the make good obligation gives rise to equal amounts of taxable and deductible temporary differences.

Transition requirements for the proposed amendments

The transition requirements proposed include a choice between:

- Full retrospective in accordance with AASB 108 *Accounting Policies, Changes in. Accounting Estimates and Errors*; or
- Full retrospective in accordance with AASB 108, except with respect to the assessment of future taxable profit required by paragraph 24 of AASB 112. The entity shall assess the extent to which it is probable that taxable profit will be available against which deductible temporary differences can be utilised only at the beginning of the comparative period.

Applying the transition relief, an entity would consider whether it meets the recoverability requirement only at the beginning of the comparative period, instead of at the date of the particular transaction.

Transition to AASB 16 *Leases*

The recognition exemption relates to the initial recognition of an asset or liability in a transaction. No transaction occurs on transition to AASB 16 because the leases existed prior to that date. We therefore believe that the initial recognition exemption cannot be applied to temporary differences arising when a company applies AASB 16 on transition to existing operating leases, and accordingly the proposed amendment will not affect these leases.

Effective date of proposed amendments

The effective date of the proposed amendments has not yet been determined, but is expected to be no earlier than periods beginning on or after 1 January 2021.

Early application is expected to be permitted once the amendments to AASB 112 are made.

Note that the Exposure Draft cannot be applied early because it is not an Accounting Standard, but it may be useful guidance in applying the existing version of AASB 112 provided it is not considered inconsistent with the existing standard. This would be the case to the extent that the proposed amendments are considered to clarify, rather than change, the existing requirements.

Practical implications of the proposed amendments

A key issue in applying the proposed amendments is determining whether the tax deductions are considered to relate to the lease asset or the lease liability. In Australia, as tax deductions are available for lease payments, we believe that these should be considered to relate to the lease liability.

In Australia, after the proposed amendments, deferred tax is expected to be recognised for the net effect of lease assets and lease liabilities for almost all leases, including on transition.

One exception is that on initial recognition of a transaction, if an entity does not recognise a deferred tax asset because it does not meet the recoverability requirement it would also not recognise a deferred tax liability.

Example 1 - Transition to AASB 16

At the date of initial application of 1 July 2019, Company A applies the modified retrospective approach 'Option 2' (where the right-of-use asset is measured at an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application). Company A initially recognises:

- a lease liability of CU1,000
- a lease asset of CU950

The difference of CU50 relates to a liability for straight-lining of lease incentives included in the statement of financial position at 30 June 2019.

Company A recognised a deferred tax asset of CU15 in the statement of financial position at 30 June 2019.

The recognition exemption does not apply. In the first financial year and subsequently Company A recognises deferred tax for all temporary differences relating to the lease. At 1 July 2017, Company A recognises a deferred tax asset of CU300 and a deferred tax liability of CU285 (at 30%). Company A then needs to consider the offsetting requirements in paragraph 74 of AASB 112 for presentation in the statement of financial position.

If Company A did not recognise a deferred tax asset of CU15 in the statement of financial position at 30 June 2019, there will be an adjustment to retained earnings of CU15 at 1 July 2019.

Example 2 - New lease

Company enters into a lease with a commencement date of 1 October 2019. Lease payments are made annually in advance. The company initially recognises (refer table below):

- a lease liability of CU1,000
- a lease asset of CU1,140

	Assets (CU)	**Liabilities (CU)**
Discounted Cash Flows	1,000	1,000
Lease prepayment prior to lease commencement	240	-
Initial direct costs incurred	20	-
Cash lease incentive received prior to lease commencement	(120)	-
Initial recorded value	**1,140**	**1,000**

The company recognises a depreciation expense for the year of CU171 and the carrying amount of the lease asset at 30 June 2020 is CU969.

The company recognises an interest expense of CU38 and the carrying amount of the lease liability at 30 June 2020 is CU1,038.

The calculations assume that tax deductions relate to the lease liability, except for the three differences between the lease liability and lease asset that relate to the lease asset.

If the company believes that the initial recognition exemption applies

The taxable temporary difference related to the lease asset is the difference between its carrying amount and its tax base. The tax base of the asset is nil. The company will not receive tax deductions for the use of the lease asset, but receives tax deductions for the initial payments of CU240 and CU20 and has assessable income for the lease incentive of CU120. The company does not recognise a deferred tax liability beyond these amounts because the recognition exemption applies.

Lease asset	Carrying amount	Tax base	Taxable temporary difference	Adjust for exemption	Adjusted temporary difference	Deferred tax liability @ 30%
Initial recognition	1,140	-	1,140	(1,000)	140	42
30 June 2020	969	-	969	(850)	119	36

There is a deductible temporary difference related to the lease liability. The tax base of the lease liability is nil as the carrying amount of the lease liability will be deductible when settled. However, the company does not recognise a deferred tax asset because the initial recognition exemption applies.

Lease liability	Carrying amount	Tax base	Deductible temporary difference	Deferred tax asset @ 30%
Initial recognition	1,000	-	1,000	-
30 June 2020	1,038	-	1,038	-

No deferred tax income or expense is recognised, except for the three differences between the lease liability and lease asset that relate to the lease asset.

Extract from profit or loss (assuming deferred tax recognition is not affected by recoverability)	Year ended 30 June 2020
Depreciation expense	(171)
Interest expense	(38)
Deferred tax income	6

If the company applied the proposed amendments (or if it believes that the initial recognition exemption does not apply)

The taxable temporary difference related to the lease asset is the difference between its carrying amount and its tax base. The tax base of the asset is nil. The company will not receive tax deductions for the use of the lease asset, but receives tax deductions for the initial payments of CU240 and CU20 and has assessable income for the lease incentive of CU120. The company recognises a deferred tax liability for the full amount of the taxable temporary difference.

Lease asset	Carrying amount	Tax base	Taxable temporary difference	Deferred tax liability @ 30%
Initial recognition	1,140	-	1,140	342
30 June 2020	969	-	969	291

There is a deductible temporary difference related to the lease liability. The tax base of the lease liability is nil as the carrying amount of the lease liability will be deductible when settled. The company recognises a deferred tax asset.

Lease liability	**Carrying amount**	**Tax base**	**Deductible temporary difference**	**Deferred tax asset @ 30%**
Initial recognition	1,000	-	1,000	300
30 June 2020	1,038	-	1,038	312

Deferred tax income is recognised in full. This results in an effective tax rate of 30% in relation to the lease transactions.

Extract from profit or loss (assuming deferred tax recognition is not affected by recoverability)	**Year ended 30 June 2020**
Depreciation expense	(171)
Interest expense	(38)
Deferred tax income	63

Further information

For further information on any of the information included in this Technical Accounting Alert, please get in touch with your local Grant Thornton Australia contact or a member of the National Assurance Quality Team at national.assurance.quality@au.gt.com.