INVITATION FOR FEEDBACK AND VIEWS

Tax Implications Arising from the Adoption of FRS 116 Leases

May 2017

Contents

1 New Approach to Lease Accounting[1]

1.1 FRS 116 *Leases*, the Singapore equivalent of IFRS 16 *Leases*, was issued by the Accounting Standards Council on 30 June 2016, and is effective for annual financial periods beginning on or after 1 January 2019, for entities under the Singapore Financial Reporting Standards Framework or the new Singapore financial reporting framework equivalent of IFRS for Singapore-incorporated listed entities. Industry sectors most impacted are airline, retail, travel and leisure, transport, telecommunications and energy, that is, businesses which lease major items such as aircraft, properties, manufacturing facilities, ships, transportation equipment, and other high-value assets.

1.2 Businesses use leasing as a means of gaining access to assets, obtaining financing, and reducing exposure to the risks of asset ownership. Leasing activities which qualify as operating leases under the existing leasing accounting standard FRS 17 (or IAS 17) are accounted for off-balance sheet, that is, both the assets utilised and the contractual obligations to pay the lessor over the lease term are not recognised as assets or lease liabilities respectively on the balance sheet.

1.3 But all these will change for operating leases under the new FRS 116. Financial statements of lessees will be more transparent with the recognition of lease assets and lease liabilities on the balance sheet, the recognition of depreciation on right-of-use assets and interest expense for lease liabilities on the income statement, and the reduction in operating cash outflows and increase in financing cash outflows in the cash flow statement. Key financial statement implications are the bringing of more debts onto the balance sheet and the front loading of total lease expenses. Concerning the latter, operating lease expenses are currently charged to the income statement on a straight-line basis over the life of the lease, but this will change with higher interest expenses charged in the earlier years, which together with typically straight-line depreciation of the right-of-use asset, will result in the front loading of total lease expenses.

1.4 Going forward, lessees will recognise leases on the single on-balance sheet lease accounting model, and account for operating leases in a manner similar to finance leases. The new accounting standard, FRS 116 Leases does not change substantially the accounting for finance lease under the old accounting standard FRS 17 Leases. The main difference relates to the treatment of residual value guarantee provided by a lessee to a lessor, for which FRS 116 requires that the lessee recognises only amounts expected to be payable under residual value guarantees, rather than the maximum amount guaranteed, as required by FRS 17.

1.5 FRS 116 substantially carries forward the lessor accounting model in FRS 17. However certain selected elements of FRS 17 are changed under FRS 116 – accounting for subleases, initial direct costs and lessor disclosures.

[1] This is extracted from the August 2016 issue of ISCA Journal – FRS 116: Leases: Getting a Balance Perspective.

2 Current Accounting and Tax Treatment

2.1 The following tables show the current accounting and tax treatment under FRS 17:

Table 1: From the lessee's perspective

Type of Lease	Under FRS 17	Current Tax Treatment
Finance Lease	Balance Sheet Leased asset Lease payable Profit or Loss Interest expense Depreciation expense	Finance lease not treated as a sale for tax purpose (pure finance lease) Lease payment (i.e. interest and capital repayment) deductible on incurred basis. Capital allowances ("CA") not allowed on lease assets.
Finance Lease Treated as a Sale (refer to 2.2)	Balance Sheet Leased asset Lease payable Profit or Loss Interest expense Depreciation expense	Finance Lease Treated as a Sale for tax purpose Interest portion of lease payment deductible Capital repayment not deductible CA allowed on leased assets
Operating Lease	Balance Sheet No asset Profit or Loss Rental expense	Lease payment deductible on incurred basis CA not allowed on leased assets

Table 2: From the lessor's perspective

Type of Lease	Under FRS 17	Current Tax Treatment
Finance Lease	Balance Sheet Lease receivable Profit or Loss Interest income	Finance lease not treated as a sale for tax purpose (pure finance lease) Tax on lease payments (i.e. interest and capital repayment) CA allowed on leased assets
Finance Lease Treated as a Sale (refer to 2.2)	Balance Sheet Lease receivable Profit or Loss Interest income	Finance Lease Treated as a Sale for tax purpose Tax on interest income on accrual basis Capital repayment not taxable CA not allowed on leased asset
Operating Lease	Balance Sheet Asset Profit or Loss Rental income Depreciation expense	Tax on lease payments (rental income) Note: taxpayer can elect administrative concession to align rental income with accounting treatment CA allowed on leased asset

2.2 Regulation 4(1) of the Income Tax (Income from Finance Leases) Regulations states that:

For the purposes of regulation 3[2], a finance lease shall be treated as a sale agreement if —

(a) the lessee has an option to purchase the machinery or plant during the term of the lease including any extension or renewal thereof or upon its expiry;
(b) the machinery or plant which is leased is a limited use asset;
(c) the machinery or plant in a sale and lease-back transaction has been previously used by the lessee or any other person;
(d) the lessor and lessee are related to each other and —
    (i) the lessee or any other person related to the lessee lends to the lessor any of the funds necessary to acquire the leased asset or guarantees any debt of the lessor incurred in connection with the lease;
    (ii) the terms of the lease are determined otherwise than on the basis that there is no such relationship between the lessor and the lessee; or
    (iii) the total value of the rentals or hire received or receivable for the term of those finance leases entered into by the lessor with lessees, who are related to the lessor, at any time during the basis period for any year of assessment exceeds half of the total value of the rentals or hire received or receivable for the term of all finance leases entered into by the lessor in that basis period; or
(e) the lease is a leveraged lease unless the Comptroller determines that it shall be treated otherwise.

[2] Regulation 3 of Income Tax (Income from Finance Leases) Regulations states that allowances under section 19, 19A, 20, 21, 22 or 23 of the Income Tax Act in respect of any machinery or plant which is leased under a finance lease shall be made to the lessee if the finance lease is treated as a sale agreement.

3 Invitation for Feedback and Views

3.1 FRS 116 makes significant changes to the existing leases accounting by lessees especially with the removal of differentiation between operating lease and finance lease. Lessor accounting is also impacted but to a lesser degree.

3.2 Under the current income tax treatment for leases, a lessee’s operating lease payments will be deducted for tax purposes on an incurred basis. Similarly, a lessee’s finance lease payments (interest and capital repayment) will be deducted for tax purposes on an incurred basis unless the finance lease is treated as a sale for tax purpose.

3.3 With the removal of the divide between operating lease and finance lease for lessees under FRS 116, there would be implications to the existing tax treatments.

3.4 ISCA welcomes feedback/views on the implications of the new FRS 116 to the current income tax treatment for leases. Suggestions on proposed changes to existing income tax rules are also welcomed.

3.5 Please note that all feedback received will shared with the Inland Revenue of Singapore (IRAS) for its consideration in the tax policies with regards to FRS 116. In addition, all feedback received will be attributed to the respective respondents unless they specifically request ISCA not to do so. As such, if respondents would like their identity to be kept confidential, please state so in the submission to ISCA.

3.6 Please submit written comments by 30 May 2017 to –

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Electronic submission is encouraged.