Impact Summary: Income tax treatment of leases subject to NZ IFRS 16

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment (RIA), except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with a policy change to be taken by or on behalf of Cabinet.

Key Limitations or Constraints on Analysis
Officials do not hold operating lease payments data for all IFRS[1] taxpayers. Estimating the total amount of annual operating lease payments for all IFRS taxpayers was necessary to determine the fiscal cost of the proposals. We identified the population of IFRS taxpayers and extracted operating lease information on the approximately 43% (by value of income tax payable) of IFRS taxpayers where it was available. This was then used to estimate lease payments for the balance of the population on the assumption their lease payments would be in the same proportion to their income tax payable. This identified total operating lease payments for all IFRS taxpayers of approximately $2.5 billion per annum. Two other factors that influence the fiscal cost are the average lease term (higher cost for longer terms) and the interest rate (higher cost for higher rates). We could not identify data on average lease terms so estimated these for a variety of situations then checked their reasonableness with external stakeholders. The interest rate on leases will differ from lease to lease and taxpayer to taxpayer; whereas the forecasting model requires a single interest rate. We chose the NZ dollar BBB+ rated corporate 5-year fixed term interest rate on 20 June 2019 which was the date the calculation was performed. In costing the proposals we have assumed that lease payments will remain static over time. A more realistic assumption is that, due to inflation and economic growth, lease payments will slowly grow over time. If this was factored into the costing there would be a small ongoing cost to the proposals; however, this cost would be very small so has been disregarded on a materiality basis. We have also assumed that, for the preferred option, all eligible taxpayers will elect to follow their accounting treatment for eligible leases. This is the most conservative assumption, but we expect the proportion will be very high. We have not attempted to estimate the exact percentage expected to elect.

[1] International Financial Reporting Standards – The requirement to prepare accounts under IFRS varies but the most common is having total assets in excess of $60 million or total revenue in excess of $30 million. In 2017 the External Reporting Board (XRB) identified 2,575 entities with IFRS reporting obligations based on 2015 data.

While changes in these assumptions or the final values will affect the fiscal calculations, officials consider these are sufficiently accurate that they can be relied upon to make decisions on the underlying principles considered.
Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the *Income tax treatment of leases subject to NZ IFRS 16* RIA and considers that the information and analysis summarised in it **meets** the quality assurance criteria of the Regulatory Impact Analysis framework.
Reviewer Comments and Recommendations:
Comments from the review of earlier versions of this RIA have been incorporated into this version.
Responsible Manager (signature and date):
Chris Gillion Policy Lead Policy and Strategy Inland Revenue 17 October 2019

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

A lease involves one person (known as the lessor) who owns (or otherwise holds) an asset providing it to another person (known as the lessee) to use in exchange for payment over the term of the lease. For entities with IFRS[2] reporting obligations, the accounting treatment was previously determined under *New Zealand Equivalent to International Accounting Standard 17 Leases* (NZ IAS 17). This standard has been replaced by *New Zealand Equivalent to International Financial Reporting Standard 16 Leases* (NZ IFRS 16 or IFRS 16) for years starting on or after 1 January 2019.[3]

Accounting treatment under NZ IAS 17

Under NZ IAS 17, there was a difference in the accounting treatment between operating and finance leases. NZ IAS 17 defines the distinction as follows:

> *A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.*

For example, a lease would be classified as a finance lease if the lessee leased the asset for the majority of its estimated useful life then had the right to purchase it from the lessor for a fixed price at the end of the lease. In contrast, a lease would be classified as an operating lease if the lessee only leased the asset for a short portion of the estimated useful life then at the end of the lease it was returned to the lessor to lease or sell to someone else.

Current tax treatment

The Income Tax Act 2007 contains two separate sets of rules for finance and operating leases. These definitions are similar but not identical to the NZ IAS 17 definition. The largest difference is that all leases of real property[4] are operating leases for tax purposes. For finance leases, the lease payments are taxed under the financial arrangements rules and are treated like the repayment of a loan with interest. For operating leases, the lease payments are currently spread equally over the life of the lease. This treatment is similar to the NZ IAS 17 accounting treatment which reduces the need for tax adjustments.

No changes to the tax treatment of tax finance leases are considered in this RIA.

Accounting changes moving from NZ IAS 17 to IFRS 16

For lessees, IFRS 16 removes the distinction between operating and finance leases for accounting purposes. Under IFRS 16, lessees are required to recognise on their balance sheet a new asset, being the right to use the leased asset for the lease term, and a lease liability representing the obligation to pay rentals.

[2] Refer to footnote 1 for an explanation of who is required to follow IFRS 16.

[3] IFRS 16 can also be applied for earlier periods for entities that choose to do so and meet certain other criteria.

[4] Real property is not specifically defined but generally relates to land and buildings.

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This RIA does not attempt to explain how accounting expenditure is calculated under IFRS 16; however, there is usually a slight acceleration of deductions compared to accounting under NZ IAS 17. This can be shown in the following simplified example for a 5-year lease, that was an operating lease under NZ IAS 17, with $100,000 per year of lease payments and a 3.7237%[5] discount rate:

Year	NZ IAS 17 Expenses	IFRS 16 Expenses
1	100,000	106,439
2	100,000	103,337
3	100,000	100,120
4	100,000	96,783
5	100,000	93,322
Total	500,000	500,000

The NZ IAS 17 treatment matches the cashflows of the lease, whereas IFRS 16 more closely matches the economic cost of the lease. The IFRS 16 treatment can be thought of similar to a typical fixed-rate mortgage where total payments are consistent over time, but the interest expenditure is higher in earlier periods when the loan is higher, and the interest expenditure is lower (and therefore capital repayments are higher) near the end of the loan when the amount outstanding is lower. Capital repayments are not deductible; however, for an IFRS 16 operating lease, the capital has been applied to acquire the right to use the asset which is deductible as depreciation over the term of the lease.

IFRS 16 does not significantly change the accounting treatment of leases for the lessor. The lessor will continue to reflect the leased asset on their balance sheet for operating leases. This RIA does not consider changes to the tax treatment of the lessor.

Policy opportunity

The introduction of IFRS 16 provides an opportunity to more closely align the tax treatment of lessees' operating leases with the new accounting treatment. This has two main objectives:

- Efficiency - As finance leases and debt used to purchase assets is already taxed under the financial arrangements rules deductions are accelerated similar to the IFRS 16 example above. Aligning the tax treatment of operating leases with the IFRS 16 treatment will make the tax treatment of all three methods of asset acquisition more similar which will reduce the tax incentive to choose one method over another to obtain a tax advantage.
- Compliance costs - Unlike when entities followed NZ IAS 17, an entity following IFRS 16 will need to make tax adjustments to remove accounting deductions and claim tax deductions. By following IFRS 16 for tax the number of adjustments required could be reduced and therefore compliance costs would be lower as would be the possibility of inadvertent error.

[5] This is the same rate used to forecast the fiscal impact of the proposals as discussed in the Key Limitations or Constraints on Analysis section of this RIA.

Timing cost

As shown in the example above, total deductions under both NZ IAS 17 and IFRS 16 are identical; however, when broken down they are slightly higher in earlier years and slightly lower in later years under IFRS 16. Accelerating the timing of deductions in this way results in a permanent fiscal cost to the Crown. The appendix to this RIA provides an example to explain how this cost arises.

2.2 Who is affected and how?

Businesses seeking to acquire an asset have a choice of financing structures including outright purchase (often funded by borrowing), finance leases and operating leases. IFRS 16[6] provides an opportunity to more closely align the tax treatment of operating leases with how finance leases and debt funded asset purchases are treated. This will reduce the tax incentive for businesses to acquire assets under a particular structure due to their different tax treatment.

More closely aligning tax and accounting treatments also reduces the compliance costs of having to make tax adjustments and reduces the chances that these adjustments will inadvertently be made incorrectly.

All IFRS taxpayers consulted supported alignment of tax with accounting for these reasons, provided it was on an optional basis.

2.3 Are there any constraints on the scope for decision making?

There is a distinction in the tax treatment between operating and finance leases and there was previously a (slightly different) distinction in the accounting treatment between operating and finance leases. The adoption of IFRS 16 has removed this distinction for accounting purposes. Officials consider the tax distinction between operating and finance leases is well understood and working as intended so removing or amending this boundary has not been considered. Instead, the project has been limited to changes aimed at simplifying the tax treatment of leases that would have previously been, and will continue to be, classified as operating leases for tax.

While there are undoubtedly benefits of aligning tax with IFRS 16 for affected taxpayers, early discussions with stakeholders identified that taxpayers wanted alignment to be optional rather than compulsory. As this project is intended to be a taxpayer favourable simplification all of the options in this RIA are for optional alignment rather than applying to all IFRS taxpayers. While this will marginally reduce efficiency, officials do not expect this to be material, especially given the small number of IFRS taxpayers expected not to elect.

[6] Refer to footnote 1 for an explanation of who is required to follow IFRS 16.

While allowing non-IFRS taxpayers to follow an IFRS 16-type treatment for tax would also offer efficiency benefits, officials have not considered extending this treatment to non-IFRS taxpayers. This is because IFRS 16 calculations are relatively complicated and are not required for accounting purposes for non-IFRS taxpayers so requiring or allowing them for tax would require complex calculations solely for tax purposes. This would have a high compliance cost that would outweigh any efficiency benefit available.

Section 3: Options identification

3.1 What options have been considered?

The following criteria were used to assess the options considered:

- *Efficiency*: the option should align with the economic substance and the accounting treatment of tax operating leases as much as possible.
- *Sustainability*: the option should follow existing income tax deductibility principles and should not offer a more favourable treatment compared with that available to non-IFRS taxpayers.
- *Compliance costs*: the compliance cost should be minimised as far as possible.

Option 1: Status quo

This option would retain the existing cashflow treatment of operating leases for lessees who are IFRS taxpayers. Once IFRS taxpayers adopted IFRS 16 they would be required to make tax adjustments to reverse accounting expenses and claim deductions consistent with the current treatment.

This would not provide any of the benefits of alignment. Compliance costs may (depending on specific decisions and taxpayer circumstances) be lower than under some variants of option 3 but would be higher than under option 2 or option 4.

Option 2: Full alignment

This option would allow lessees to claim tax deductions equal to their accounting expenditure under tax operating leases.

This would provide the highest level of efficiency, and compliance cost savings, as it would fully align tax and accounting. However, it would not be sustainable – it would offer a significant more favourable treatment that that available to non-IFRS taxpayers and would have a significant fiscal cost (estimated at approximately $400 million[7]).

[7] As with the cost estimates for Option 3 and Option 4 this cost is the total cost of this option over all time periods. The time period is dependent on the transitional period chosen which has agreed to be 5 years. Changing the transitional period changes the period the cost arises over but doesn't change the total cost. There are no costs beyond this transitional period. Refer to the appendix of this RIA for a more detailed explanation.

Option 3: Full alignment with adjustments

This option would allow lessees to mostly claim tax deductions equal to their accounting expenditure under tax operating leases but would require them to make adjustments to recognise the tax principle that tax deductions should (generally) be available only when expenditure is incurred. This is in contrast to a number of items included in IFRS 16 lease expenditure, such as fair value impairments[8] – which are closer to a provision and provisions are not usually deductible – and make good costs[9] – which are spread over the (remaining) term of the lease rather than when the expenditure is incurred.

This would have similar, or slightly lower, sustainability than option 4. However, it would have a fiscal cost of approximately $89 million assuming all IFRS taxpayers elected to align tax and accounting. It would significantly increase compliance costs as the calculation of adjustments would be complex and would have to be regularly updated. This increase in compliance costs would likely result in many taxpayers choosing not to align tax and accounting as the compliance costs could outweigh the benefits. If the proportion of taxpayers choosing to align tax and accounting was similar to option 4 then this option would have higher efficiency (due to the coverage of more leases); however, due to the increased compliance costs its likely less taxpayers would choose to align resulting in lower efficiency than option 4.

Option 4: Partial alignment with adjustments

This option is the same as option 3 except it would exclude operating leases for real property which would continue to be deductible under the current tax treatment. Real property is a term within the leasing rules and takes its ordinary legal meaning. It can be thought of as land and buildings. A lease of real property cannot be a finance lease for tax purposes even when the terms of the lease would otherwise make it so. Many businesses will have more non-real property leases than real property leases. However, real property leases are typically for longer terms and over higher value assets, so the total value of real property leases is expected to be far higher.

This option does not capture the full efficiency benefits due to its narrower scope of covered leases so is worse than option 2 based on this criterion but still higher than option 1 (which does not align at all) and option 3 (due to the expected low take-up of the optional alignment). This option has significantly lower compliance costs than option 3 as most of the adjustments that would be required under option 3 would not frequently arise in non-real property leases (for example, businesses often must restore a commercial building at or before the end of the lease whereas they don't have to do this with a vehicle lease). It is the most sustainable as it is not significantly more favourable compared with the treatment by non-IFRS taxpayers and also has the lowest cost (approximately $9 million) of any option other than the status quo.

[8] Fair value impairments are recorded as an accounting expense when the value of the asset to the business is less than that recognised in the accounts. For example, when a business is contracted to keep making lease payments on a building but no longer wants to operate from that site.

[9] Make good costs are the estimated costs of restoring an asset before it can be returned to the lessor. For example, removing fitout from a building.

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3.2 Which of these options is the proposed approach?
Option 4 is the preferred option. It will align tax and accounting for the greatest number of leases given the constraints of not creating a significantly more favourable set of rules for IFRS taxpayers that is not available to other businesses. This option will minimise compliance costs to the extent possible as it is expected that a high proportion of eligible taxpayers will elect to follow it. We have not attempted to estimate what proportion would choose to align tax and accounting but as the rules will reduce compliance costs and marginally bring forward deductions there will be few reasons not to elect to align. The forecasts conservatively assume that 100% of eligible taxpayers will elect to do so. There are no areas of incompatibility with the Government's 'Expectations for the design of regulatory systems'.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs of proposed approach, compared to taking no action		
Lessees who follow IFRS and elect to follow the accounting treatment for tax	Need to monitor accounting entries that must be adjusted for tax	Low – will require ongoing monitoring but few adjustments are expected for non-real property leases
Wider government	Permanent reduction in tax revenue from deductions being brought forward	$9m over 5-year transitional period. No costs for years after this.
Total Monetised Cost	Reduction in tax revenue	$9m over 5 years.
Non-monetised costs	Ongoing monitoring of tax adjustments	Low

Expected benefits of proposed approach, compared to taking no action		
Lessees who follow IFRS and elect to follow the accounting treatment for tax	Removal of need to adjust between accounting and tax deductions Timing benefit from deductions being brought forward so tax will be paid slightly later[10] Reduction in tax incentive to enter into different acquisition structures	Medium Medium Medium
Inland Revenue	Reduction in monitoring of tax adjustments for operating leases	Low – some adjustments will still be required but the number of adjustments will be significantly reduced.
Total Monetised Benefit	None	N/A
Non-monetised benefits	Marginal acceleration of lease deductions Reduction in compliance costs for lessees to comply with tax obligations and reduction in administration costs for Inland Revenue reviewing this treatment.	Figure unable to be quantified on an individual lessee basis Medium

4.2 What other impacts is this approach likely to have?
None identified.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?
Officials undertook targeted consultation with large corporates who enter into operating leases, their advisors, and relevant representative groups. Stakeholders were supportive of the simplification benefits of more closely aligning tax and accounting for operating leases for IFRS taxpayers provided this was on an optional basis (as the preferred option does and as discussed in section 2.3 above). Stakeholders generally sought a full alignment with few, and preferably no, adjustments from the accounting position on the basis this would minimise compliance costs. For the reasons

[10] This cost is permanent to the Crown as it considers the economy as a whole where new leases are always entered into (refer to the appendix of this RIA for more explanation). In contrast, taxpayers enter individual leases where the benefit is only the slight acceleration of deductions but the same total deductions over the life of the lease, so this has only a timing benefit.

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set out above we do not recommend a full alignment. However, the exclusion of real property leases is likely to significantly reduce the number of adjustments that will be required. There have been varying degrees of support from individual stakeholders on the decision to exclude real property.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

The proposals will require amendments to the Income Tax Act 2007 which could be included in the next available tax omnibus bill expected to be introduced in early 2020. This bill is unlikely to be enacted before late 2020 or early 2021 which is after the application date of IFRS 16 – on or after 1 January 2019.

For the earliest possible balance date that IFRS 16 would apply to, of 31 December, the first tax year following IFRS 16 will end on 31 December 2019. This is the 2019/20 tax year and the relevant return will be due to be filed by 31 March 2021 for taxpayers with an extension of time for filing their returns.

Therefore, in most instances, affected taxpayers will have started their first-year accounting under IFRS 16 before the enactment of the bill containing the proposals but will not file a tax return until shortly after the enactment of that bill.

For a taxpayer who chooses not to elect to align tax and accounting in the 2019/20 year, they should be able to elect to do so in any subsequent year. But all taxpayers, once they elect to align tax and accounting treatment, should be required to do so in all future years where they follow IFRS for accounting purposes.

When a taxpayer chooses to elect to follow the accounting treatment for tax purposes this will usually result in a one-off deduction (arising from deductions that would have been available had the taxpayer been able to follow IFRS 16 in previous periods but were not available under the previous treatment). In order to manage the fiscal cost of this transition to the Crown, we suggest this deduction is spread over the year of adoption and the following four years. Consulted stakeholders have been supportive of this approach.

Inland Revenue will release details of the Cabinet decision once it is made and further detail will be provided in a commentary released when the Bill is introduced and will also be included in the Tax Information Bulletin after the Bill is enacted.

Inland Revenue will be responsible for the ongoing monitoring and enforcement of the rules.

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Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
No specific data collection or monitoring is expected. Inland Revenue maintains a close relationship with many of the small number of affected large taxpayers and has a specific contact for IFRS issues. Any issues with the proposals or their post enactment implementation are expected to be identified through these channels or through contact with Policy staff.

7.2 When and how will the new arrangements be reviewed?
• *How will the arrangements be reviewed? How often will this happen and by whom will it be done? If there are no plans for review, state so and explain why.* • *What sort of results (that may become apparent from the monitoring or feedback) might prompt an earlier review of this legislation?* • *What opportunities will stakeholders have to raise concerns?*
The final step in the Generic Tax Policy Process is the implementation and review stage, which involves post implementation review of legislation, and the identification of remedial issues. A post implementation review could occur around 12 months after implementation. Any recommended changes identified from the review would be considered for potential inclusion on the Government's tax policy work programme.

Appendix: Timing cost example

As referred to in section 2.1, this example explains how a permanent reduction in tax revenue arises from the acceleration of lease deductions even where total deductions for each lease are unchanged.

Assume, each year a three-year lease is entered into with $100 of deductions each year. The total deductions will be $300 each year as follows:

Year	1	2	3	4	5	6	7
Lease 1	100	100	100				
Lease 2		100	100	100			
Lease 3			100	100	100		
Lease 4				100	100	100	
Lease 5					100	100	100
Lease 6						100	100
Lease 7							100
Total			**300**	**300**	**300**	**300**	**300**

Instead, assume the timing of deductions is changed to $105, $100 and $95 for all leases starting from lease 4.

Year	1	2	3	4	5	6	7
Lease 1	100	100	100				
Lease 2		100	100	100			
Lease 3			100	100	100		
Lease 4				105	100	95	
Lease 5					105	100	95
Lease 6						105	100
Lease 7							105
Total			**300**	**305**	**305**	**300**	**300**

This shows that annual deductions start at $300 and return to $300 in year 6 onwards but in years 4 and 5 increase to $305. This $5 increase in deductions, if taxable at 28%, would permanently decrease tax revenue by $1.40 for both year 4 and year 5.

If, in a future year, leases were no longer entered into this cost would reverse as there would be less deductions available. However, on an economy wide basis it is reasonable to assume that leases will continue to be entered into so this cost should be treated as permanent.

Detail decisions such as whether to apply to existing leases or to spread a transitional adjustment over multiple years will affect the year the fiscal cost arises in but will not alter the total cost of the decisions in this RIA.

Due to inflation and economic growth it would be more accurate to assume a small increase in lease payments each year rather than this example's static lease payments. The consequence of such an assumption would be to create a small ongoing cost from an acceleration of lease deductions. However, this effect is not expected to be significant so has been omitted from the analysis.