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International Financial Reporting Standard 16

Does it affect Uganda's Tax Treatment of Leases?

Cristal Tax Series

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1. Introduction

Leasing provides an alternative means of asset acquisition with payment spread over a period of time matching the use of the asset. Leasing represents contractual arrangements where the lessee (user) pays the lessor (owner) for the use of an asset. Items of property, plant and equipment are the most commonly leased assets. The lessor is the legal owner of the asset while the lessee obtains the right to use the asset in return for regular rental payments. Asset usage covenants are usually imposed by the lessor.

Effective 1st January 2019, International Financial Reporting Standard 16 ("IFRS 16") came into force replacing International Accounting Standard 17 ("IAS 17") that previously regulated the accounting treatment of leases. IFRS 16 introduces a uniform accounting treatment for enterprises using leased assets (though with minor exceptions). The accounting treatment under IAS 17 depended on the classification of the lease as either an operating or finance lease, a distinction with different tax and commercial consequences.

International Financial Reporting Standards ("IFRS") developed by the International Accounting Standards Board ("IASB") have been adopted by the Institute of Certified Public Accountants of Uganda ("ICPAU"). ICPAU is the body mandated under the Accountants Act 2013 to set accounting standards for both the public and private sector in Uganda. IASB not only develops high quality and globally enforceable IFRS but also promotes their use and application to foster trust, growth and long term stability in the global economy. Corporate failures in the past attributed to false or misleading accounting undermined the confidence of the public in the accounting profession. IASB therefore continually examines the global economy and environment to come up with robust and rigorous accounting standards in public interest that foster integrity to enhance global trust in corporate financial reporting.

In this publication, we examine whether the changes to the accounting treatment of leases steered by IFRS 16 affect the tax treatment of leases in Uganda.

2. The accounting treatment for leases under IAS 17

IFRS 16 replaces IAS 17 that previously spelt out the accounting guidelines for leases. At inception, a lease was classified under IAS 17 as either an operating or finance lease on the evaluation of the substance of the transaction rather than the legal form. The classification depended on the extent to which the risks and rewards incidental to the ownership of the leased asset lay with the lessor or lessee. In general terms, operating leases were kept off balance sheet while finance leases were recognised as liability on the lessee's balance sheet.

a) Finance lease

Under a finance lease, the risks and rewards of asset ownership are substantially born by the lessee despite legal title remaining with the lessor. Some of the circumstances relied upon to infer the existence of a finance lease under IAS 17 include:

- the lease transfers ownership of the asset to the lessee by the end of the lease term;
- the lessee can purchase the asset at a price significantly lower than the fair value at the date this right is exercisable;
- the lease term is for the major part of the economic life of the asset;
- at inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset;
- the leased assets are of such a specialised nature that only the lessee can use them without major modifications;
- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- gains or losses from the fluctuation in the fair value of the residual accrue to the lessee;
- the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

Please note that not all the tests set out above need to be satisfied in a single transaction. What is key to look out for is whether any of the circumstances above indeed demonstrate that the risks and rewards of asset ownership have been substantially transferred to the lessee.

b) Operating lease

Any lease arrangement not classified as a finance lease in accordance with the criteria set out above is treated as an operating lease under IAS 17. The lessee rents an asset from a lessor in return for periodic rental payments under an operating lease. The lessee never owns the asset and at the end of the lease term, the asset returns to the lessor. The rewards and risks of ownership of the asset remain with the lessor.

c) The accounting treatment for operating and finance leases

An operating lease is akin to a rental transaction under IAS 17. The lessee treats the lease rental payment as an expense in their income statement when due. If rental payments are paid in advance for a number of months, the lessee records a prepayment in their balance sheet that is reduced each month with the corresponding rent due.

The lessor books the rental payment as revenue in their income statement and depreciates for accounting purposes the leased asset including the recognition of any expenses incurred in maintaining the asset under an operating lease.

Under a finance lease, IAS 17 requires that the lessee recognises the right of use of the leased asset as a capital asset on their balance sheet and sets up a corresponding liability representing the obligation to make lease payments to the lessor. The lease payments are apportioned between the finance charge and the reduction of the outstanding liability. Following the initial capitalisation of the leased asset, depreciation is charged on the asset by the lessee. The lessee also recognises any expenses incurred in maintaining the leased asset.

Under IAS 17, the lessor books the lease payment as a receivable in their balance sheet under a finance lease and interest as revenue in the income statement.

3. The accounting treatment of leases under IFRS 16

IFRS 16 retains the lease definition in IAS 17 but changes direction on its application. For most purposes, it eliminates the classification of leases as either operating or finance for a lessee. Lessors however continue to classify leases as operating or finance leases substantially unchanged from IAS 17.

Under IFRS 16, all leases of more than 12 months are recognised on a lessee's balance sheet as a right-of-use asset and liability except for some limited exceptions. The liability and right-of-use asset are unwound over the term of the lease giving rise to an interest expense and depreciation charge respectively. The addition of leases to the balance sheet means that many companies will experience a corresponding increase in their debt levels and a reduction in EBITDA as expenses related to the leased asset will now form part of interest expense and depreciation). EBITDA refers to Earnings before Interest, Taxes, Depreciation and Amortisation.

Lessees are permitted under IFRS 16 to apply a method similar to IAS 17's operating lease accounting for leases with a term of 12 months or less or for which the underlying asset is of low value. In other words, they are not required in such cases to capitalise the leased asset or create a corresponding liability in their balance sheet.

Similar to the position under IAS 17, lessors will continue to account for leases as either operating or finance leases depending on whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset to the lessee. Operating leases continue to be recorded as assets in the balance sheet of the lessor and lease income is recognised on a straight-line basis over the lease term.

For finance leases, a lessor derecognises the underlying asset and records a receivable equal to the net investment in the lease, with a gain or loss on sale.

4. Uganda's Income tax position

Despite the changes in the accounting treatment of leases ushered in by IFRS 16, Uganda's income tax position on the treatment of leases remains unchanged and is largely hinged on whether the lease in question falls within the definition of a finance or operational lease in the Income Tax Act ('ITA') as we discuss further below.

a) Finance lease

The ITA provides that where a lessor leases property to a lessee under a financing lease, the lessee is treated as the owner of the property and the lessor is treated as having made a loan to the lessee, in respect of which payments of interest and principal are made to the lessor equal in amount to the rental payable by the lessee. The interest component of each payment under the loan is treated as an interest expense incurred by the lessee and interest income derived by the lessor.

A lease of property is a finance lease under the ITA if the lease term exceeds 75% of the effective life of the leased property; the lessee has the option to purchase the property for a fixed or determinable price at the expiration of the lease or the estimated residual value of the property to the lessor at the expiration of the lease market is less than 20% of its fair market value at the commencement of the lease.

- The lessee or person taking out the lease capitalises the leased asset and takes a deduction of the applicable tax depreciation. The lessor should not claim the tax depreciation on the leased asset despite still retaining legal title to the asset.
- Interest payments subject to exemptions attract withholding tax ("WHT") the rate of which is dependent on whether the payment is made to a resident or non-resident tax person (and in the latter case may be impacted by an applicable double tax treaty).

b) Operating lease

Any lease arrangement not qualifying as a finance lease is an operating lease under the provisions of the ITA and is taxed accordingly.

- The lessor can claim tax depreciation in respect of the asset leased out in accordance with the applicable tax depreciation rates set out in the ITA;
- The lessee takes a deduction of the rental payments in determining their taxable profits;
- Subject to the applicable exemptions, rental payments to the lessor potentially attract WHT in Uganda at the rate of 6% if they in aggregate exceed UGX 1 million and the payer is a designated WHT agent;
- Subject to the application of any relevant double tax treaties, rental payments are also subject to the WHT at the specified rate if made to a non-resident person/lessor.

5. Uganda's Value Added Tax position

Both finance and operating lease arrangments are subject to VAT at the standard rate of 18 per cent. Though from an income tax perspective, a finance lase is accounted for as if it were the making of a loan to fund the purchase of the asset in question, the VAT treatment of a finance lease follows the legal form of the transaction which is the hiring of an asset by the lessor to a lessee.

Under the Value Added Tax Act ("VATA"), leasing of assets is a taxable transaction for VAT purposes and is subject to VAT at the rate of 18%. (It is not treated as a VAT-exempt financial service.) Lessors therefore have the obligation to charge VAT on leasing transactions with the same being remitted to the URA.

The VAT incurred by the lessee can be claimed as input VAT to the extent it is not blocked under section 28 of the VAT Act.

6. Uganda's stamp duty position

A number of instruments set out in the Stamp Duty Act 2014 are subject to duty at the specified rates set out in the Act. An instrument is defined as a document by which a right or liability is, or purports to be, created, transferred, limited, extended, extinguished or recorded. Lease agreements therefore qualify as instruments in accordance with the Stamp Duty Act 2014.

7. Conclusion

As demonstrated in this publication, the accounting changes ushered in by IFRS 16 do not affect the Ugandan tax treatment of leases. This notwithstanding, the changes affect lessees who now have to recognise the right of use of an asset as a liability in their balance sheet in respect of leases in excess of 12 months. This will increase their debt levels affecting their gearing ratios and potentially capacity to take on more debt. Previously, operating leases were off balance sheet items for the lessee presenting a rosy picture of their balance sheet for further debt acquisition.

Cristal Advocates accepts no responsibility for any loss occasioned to any person acting or refraining from acting as a result of material contained in this publication. Further advice should be taken before relying on the contents of this publication.

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Dickens was instrumental in UNOC's formation and initial period of operation and also served as its head of Contracts, Negotiations and Advisory until May 2018. Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy playing key legal advisory roles on the negotiation and implementation of PSAs, Joint venture and other oil and gas agreements. He was also part of the team that shepherded the process of enacting the current Ugandan oil and gas Legislations and Regulations including the local content requirements.

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