



Demystifying the intricacies of Section 20 *Leases* in the IFRS for SMEs

YOUR KEY TO THE TAX COMMUNITY

Welcome to today's session!

Demystifying the intricacies of **Section 20 Leases** in the **IFRS for SMEs**

Agenda – points to cover in the webinar

1. Does an arrangement contain a lease?
2. Calculating the rate implicit in the lease agreement
3. Determining the present value of minimum lease payments
4. Separate classification: the lease of land and buildings
5. Initial recognition of a finance leased asset (lessee)
6. Measurement principles at initial and subsequent recognition (lessors)
7. Sale and leaseback transactions
8. Differences in tax versus accounting treatments (self-study)

The first intricacy...

A production company (the purchaser) enters into an arrangement with a third party (the supplier) to supply a minimum quantity of gas needed in its production process for a specified period of time. The supplier designs and builds a facility adjacent to the purchaser's plant to produce the needed gas and maintains ownership and control over all significant aspects of operating the facility. The agreement provides for the following:

- The facility is explicitly identified in the arrangement, and the supplier has the contractual right to supply gas from other sources. However, supplying gas from other sources is not economically feasible or practicable.
- The supplier has the right to provide gas to other customers and to remove and replace the facility's equipment and modify or expand the facility to enable the supplier to do so. However, at inception of the arrangement, the supplier has no plans to modify or expand the facility. The facility is designed to meet only the purchaser's needs.
- The supplier is responsible for repairs, maintenance, and capital expenditures w.r.t. the gas facility.
- The supplier must stand ready to deliver a minimum quantity of gas each month.
- Each month, the purchaser will pay a fixed capacity charge and a variable charge based on actual production taken. The purchaser must pay the fixed capacity charge irrespective of whether it takes any of the facility's production. The variable charge includes the facility's actual energy costs, which amount to about 90 per cent of the facility's total variable costs. The supplier is subject to increased costs resulting from the facility's inefficient operations.
- If the facility does not produce the stated minimum quantity, the supplier must return all or a portion of the fixed capacity charge.

Determining whether an arrangement contains a lease

- Based on the **substance** of the transaction (legal form could be an entirely different concept!)
- Assess whether:
 - Fulfilment of the arrangement is **dependent on the use of a specified asset?**
 - Substantive substitution rights?
 - Arrangement **conveys a right to use the asset?**
 - Purchaser has ability/right to operate the asset in a manner it determines while obtaining more than insignificant output OR
 - Purchaser has right/ability to control physical access to asset while obtaining more than insignificant output OR
 - Chances are remote that another party will take more than insignificant amount of output **AND** price that purchaser will pay is neither fixed per unit of output nor equal to current market price per unit

Application: gas plant

The arrangement DOES contain a lease within the scope of Section 20, because:

- An asset (the facility) is explicitly identified in the arrangement and **fulfilment of the arrangement is dependent** on the facility. Although the supplier has the right to supply gas from other sources, its ability to do so is not substantive.
- The purchaser has **obtained the right to use the facility** because, on the facts presented —
 - in particular, that the facility is designed to meet only the purchaser's needs and the supplier has no plans to expand or modify the facility—it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the facility's output **and**
 - the price the purchaser will pay is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output
- The lease will be treated in terms of section 20 of the IFRS for SMEs

...implied by...

“Rate implicit in the lease”

- **Rate implicit in the lease** is the discount rate at which:
 - the sum of the present value of the lease payments (MLPs) and unguaranteed residual value equals
 - the sum of the fair value of the underlying asset and any initial direct costs of the lessor
- Example: Entities A (Pty) Ltd and B (Pty) Ltd enter into a rental agreement in terms of which A (Pty) Ltd rents a machine (with a fair value of R500 000 (ex VAT)) from B (Pty) Ltd at R10 000 per month (ex VAT) for a period of 60 months. B (Pty) Ltd arranged the contract and incurred legal costs of R25 000 (including VAT). At the end of the lease agreement, entity A (Pty) Ltd will either (this will be the choice of the lessee):
 - (a) Pay the final balloon payment of R50 000 (ex VAT) to obtain the legal ownership of the machine; or
 - (b) Return the machine to B (Pty) Ltd and pay no balloon payment.

The rate implicit in the lease is calculated as follows:

$FV = R50\ 000 \times 1.15 = (R57\ 500)$ (whether this residual value is guaranteed or unguaranteed, is irrelevant to this calculation)

$PV = \text{fair value of underlying asset} = R500\ 000 \times 1.15 = R575\ 000 + \text{lessor's direct costs } R25k = R600\ 000$

$N = 12 \text{ months} \times 5 \text{ years} = 60 \text{ months}$

$P/Yr = 12 \text{ (monthly instalments)}$

$Pmt = R10\ 000 \text{ instalment} \times 1.15 = (R11\ 500)$

Hence: the rate implicit in the lease = 8.4% p.a.

“Minimum lease payments” (MLP’s)

- Important concept in lease accounting...
- **For the lessee**
 - Lease instalments i.t.o. the lease agreement
 - Guaranteed residual value (e.g., balloon payment) – this amount/value will have been guaranteed by the lessee, or by a party related to the lessee
- **For the lessor**
 - Lease instalments i.t.o. the lease agreement
 - Guaranteed residual value (e.g., balloon payment) – this amount will have been guaranteed by the lessee, a party related to the lessee **or an independent 3rd party unrelated to the lessor that is financially capable to discharge the obligation under the guarantee**

Relevance of MLP's?

- **Lessees – account for a liability**
 - Must create a finance lease obligation only for the **MLP**, as this is what a present obligation exists for at inception of the lease
 - Therefore, unguaranteed residual values not included in MLP (i.e., excluded from finance lease obligation as no unconditional present obligation exists)
- **Lessors – account for a receivable**
 - Recognise 'gross investment in the lease' (effectively a receivable) in finance lease, which comprises:
 - **MLP's** (i.e., instalments over lease term plus guaranteed residual values)
 - **Plus: unguaranteed residual values, as long as probable to be recovered**
- The above emphasises again the difference between accounting for a liability (i.e., PRESENT obligation) versus an asset (i.e., probable FUTURE economic benefits)

Example: Using the RIL to calculate PV of MLPs

The same information applies as in the example on the rate implicit in the lease...

Quick recap...

Rate implicit in the lease was **8.4% p.a.**

A (Pty) Ltd has a CHOICE to either pay the balloon payment in cash (R57 500 including VAT) or to return the machine to B (Pty) Ltd. Seeing that this choice can be exercised by A (Pty) Ltd, the lessee, this is regarded an **unguaranteed residual value** as A (Pty) Ltd is not unconditionally obliged to pay the amount and can return the machine instead.

A (Pty) Ltd is now required to calculate the **PV of MLPs**, as explained before:

Pmt = (R11 500)

I/Yr = 8.4%

N = 60

P/Yr = 12

FV = ZERO (as it is unguaranteed)

Thus: PV of MLPs = **R562 124** (remember: the fair value of the asset was **R575 000**)

Separate classification

- **Land** – normally has an indefinite economic life...
 - Therefore, lease of land = *operating lease* unless legal title transfers
 - Professional judgement required
- **Buildings** – use primary and secondary indicators...
- MLP allocated between land and buildings in proportion to **relative fair values of the leasehold interests in the land and building elements** at inception (see next slide)
 - If not possible: whole lease = finance lease, unless clearly both elements are operating leases
- *If land element = immaterial: land & buildings treated as a single unit for lease classification*

Example: info

- **Fair value of leasehold interests in:**
 - Land = R1 million (not immaterial)
 - Buildings = R4 million
- **Fair values of underlying:**
 - Land = R2 million (not immaterial)
 - Buildings = R6 million
- PV of MLP = R6 million
- Ignore VAT
- Lease of land = correctly classified as operating lease
- Lease of building = correctly classified as finance lease

Example: solution

- Dr Buildings (leased) R4.8m
- Cr Finance lease (F/P) R4.8m
- (R4m/R5m x R6m MLP)



For allocation purposes!

- Operating lease of land to be expensed as incurred



Finance leases: Lessees

Initial measurement issues

- At commencement of lease term, classification at inception!
- Recognise leased asset at an amount...
 - equal to the fair value of the leased property (R575 000)
 - or, if lower, at the PV of MLP (R562 124)
 - as determined at inception of lease
- The rate implicit in the lease to be used, if practicable, to determine PV of MLP
- Otherwise, the lessee's incremental borrowing rate (*this option is not available to lessors*)
 - This is in case the RIL cannot be readily determined as lessor's direct costs are not known
- Direct costs to be capitalised to leased asset

Dr Machine	R487 124
Dr Input VAT	R75 000
Cr Finance lease obligation	R562 124

Finance leases: Lessors

Initial recognition and measurement

- Assets held in terms of finance leases are to be **presented as receivables** in the SOFP at an amount equal to the net investment in the lease

Net investment in the lease

Gross investment in the lease

Less: Unearned finance income

100

180

(80)

MLPs + ung. RV

- Direct costs part of investment in the lease
 - Impacts rate implicit in the lease (as per definition)
 - Except for manufacturer/dealer lessors: expensed when selling profit is recognised

Finance leases: Lessors

Subsequent measurement

- Guidance for manufacturer/dealer lessors:
 - Artificially low interest rates
 - Two components of income
 - Gain on disposal of asset
 - Finance income earned
 - Cost of sale
 - = cost (or CA) **LESS PV of unguaranteed residual**
 - Direct costs expensed at commencement when selling profit is recognised

**This portion of the asset
is effectively not sold...**

Sale and leaseback: lease => finance lease

- Excess of sales proceeds over CA = deferred and amortised over lease term
- Substance is a financing transaction where asset is provided as security
 - Thus, no selling profit recognised...
- Deferred profit in SOFP is treated as a 'negative asset' (valuation allowance)
 - i.e., deducted against CA of leased asset when presented in AFS
- **Dr Bank** **R1 000 000**
- Cr Owned machinery (SoFP) R800 000
- *Cr Deferred profit (SoFP)* **R200 000**
- Dr Leased machinery (SoFP) R1 000 000
- **Cr Finance lease obligation (SoFP)** **R1 000 000**

Sale and leaseback: lease => operating lease

- **Transaction is established at fair value**

Anti-manipulation
measures...

- Recognise gain/loss on disposal in P/L

- **If $SP < \text{fair value}$**

- Recognise gain/loss on disposal in P/L
- If loss arose, and loss is compensated for by lower lease instalments: defer loss and amortise over lease term

- **If $SP > \text{fair value}$**

- Excess $>$ fair value is deferred and amortised over lease term
- Remainder recognised in profit or loss

Sale and leaseback: lease => operating lease

- If fair value (at sale and leaseback) < CA
 - Recognise impairment loss first between CA and fair value, before dealing with any lease issue
 - Impairment losses may never be deferred

SELF-STUDY

**IFRS for SMEs
Section 20 Leases**

**Summary of differences between
Tax treatment and Accounting treatment**

Operating leases: income tax

- **IFRS for SMEs = operating lease**
 - Lease instalment evenly recognised in P/L, could be equalised if uneven, then deferred tax arises (no SARS equalisation)
- **Taxation = operating lease**
 - Actual lease instalment per agreement taxed/deducted, usually ex VAT
 - Never equalised, even if uneven instalments with even benefit
 - Lessor: wear-and-tear deductions on asset leased to lessee (depends on how used by lessee)

Operating leases: VAT

- **IFRS for SMEs = operating lease**
 - Recognise VAT based on actual instalment paid/received (x15/115)
 - Do not equalise VAT when straight-lining lease instalments!!
- **Taxation = operating lease**
 - VAT claimed/paid per actual lease instalment paid/received, straight-lining irrelevant
 - Instalment x 15/115 = VAT claimed from/paid to SARS

Operating leases: take note

● Leasehold improvements

○ IFRS for SMEs:

- Lessee: capitalise debit to 'prepaid expenses' and amortise over lease term to P/L, credit bank/LTL/creditors etc. – no deferred tax arises
- Lessor: capitalise debit to PP&E and credit 'income received in advance' and amortise over lease term to P/L – deferred tax arises

○ Income tax:

- Lessee: deduct over lease term from when improvements are completed (excluding VAT) (S11g)
- Lessor: include in gross income when accrues (when contract is signed (theory)/when improvements are complete (practice)), may have once-off relief i.t.o. S11h

○ VAT:

- Accounting: capitalise VAT receivable/payable at commencement of lease term and claim back from/pay to SARS (depending on whether lessee/lessor)
- Taxation: claim back from/pay to SARS earlier of invoiced or paid

Operating leases: take note

- **Lease premium (amount paid upfront to secure lease, e.g., deposit)**
 - **IFRS for SMEs:**
 - Lessee: capitalise debit to 'prepaid expenses' and amortise over lease term to P/L, credit bank etc. – no deferred tax arises
 - Lessor: capitalise debit to bank and credit 'income received in advance' and amortise over lease term to P/L – deferred tax arises
 - **Income tax:**
 - Lessee: deduct over lease term from when available for use (excluding VAT) (S11f)
 - Lessor: include in gross income when accrues (when contract is signed), may have once-off relief i.t.o. S11h
 - **VAT:**
 - Accounting: capitalise VAT receivable/payable at commencement of lease term and claim back from/pay to SARS (depending on whether lessee/lessor)
 - Taxation: claim back from/pay to SARS earlier of invoiced or paid

Finance leases: income tax

- **IFRS for SMEs = "financed acquisition/sale"**
 - Lessee: expense interest & depreciation; amortised cost model
 - Lessor: recognise selling profit (if M/D lessor) and finance income earned (if not M/D lessor: only finance income earned recognised)
- **Taxation = operating lease**
 - Lessee: deduct lease instalments incurred, excl. VAT
 - Lessor: taxed on lease instalments accrued, excl. VAT
 - Lessor: wear-and-tear deductions claimed on cost price of leased asset, excluding input VAT when asset acquired
 - Residual value not considered i.r.o. wear-and-tear deductions

Finance leases: income tax

- Lessee/lessor: Instalment incurred/accrued deducted/included for taxation, **excluding** VAT (assuming VAT vendor, qualifying purpose etc.) **VAT Act**

“ICA”



- Remove VAT i.t.o. S23C
(weight of instalments)

“Operating lease”



- Remove VAT
(15/115 x instalment)

Note: most finance leases will qualify as ICA's in terms of the income tax act...

Finance leases: VAT

- **IFRS for SMEs = “financed acquisition/sale”**
 - If ICA (for tax): claim from/pay to SARS 100% VAT upfront
 - If rental agreement (for tax): claim/pay VAT per instalment
- **Taxation = could be ICA or rental agreement**
 - If ICA: claim from/pay to SARS 100% VAT upfront, instalments then adjusted per S23C for income tax
 - If rental agreement: claim/pay VAT per instalment, instalments then adjusted x 15/115 to remove VAT for income tax

Sale & leaseback: income tax

- **Seller-lessee**

- Taxed at 28% on recoupment, if any
- CGT at 80% on capital gain, if any

- **Lessor-buyer**

- Wear-and-tear deductions (S23D & S23G)
 - Original cost price for seller-lessee, less allowances granted to seller-lessee
 - Plus: recoupment (for seller-lessee)
 - Plus: 80% of capital gain (of seller-lessee)

Thank you for attending!

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