Hon Stuart Nash, Minister of Revenue

Information Release

Income tax treatment of leases subject to International Financial Reporting Standards

December 2019

Availability

This information release is available on Inland Revenue's Tax Policy website at http://taxpolicy.ird.govt.nz/publications/2019-ir-cab-dev-19-sub-0299/overview.

Documents in this information release

1. DEV-19-SUB-0299 - Cabinet paper: Income tax treatment of leases subject to NZ IFRS 16 (13 November 2019)

2. DEV-19-SUB-0299 - Regulatory impact assessment: Income tax treatment of leases subject to NZ IFRS 16 (17 October 2019)

3. DEV-19-MIN-0299 - Minute: Income tax treatment of leases subject to International Financial Reporting Standards (13 November 2019)

Additional information

The Cabinet paper was considered by the Economic Development Committee on 13 November 2019 and confirmed by Cabinet on 18 November 2019.

Information withheld

No information was withheld for this information release.

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Office of the Minister Revenue

Chair, Cabinet Economic Development Committee

INCOME TAX TREATMENT OF LEASES SUBJECT TO NZ IFRS 16

Proposal

1. This paper seeks the Cabinet Economic Development Committee's agreement to allow taxpayers who follow International Financial Reporting Standards (IFRS) to choose to follow their accounting treatment, with certain adjustments, for calculating tax deductions for expenditure under operating leases other than real property. [1]

2. Cabinet approval is sought as this is a policy change to the timing of lease deductions which will potentially affect all IFRS taxpayers and has a $9 million fiscal cost over 5 years.

Executive Summary

3. Taxpayers who have IFRS reporting obligations[2] are required to follow the new accounting standard *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.

4. IFRS 16 changes the timing of accounting expenditure for lessees (the person with use of the asset) compared to the previous treatment; but total deductions are unchanged over the life of the lease. I propose that lessees who follow IFRS should be able to elect to follow, subject to certain adjustments, their IFRS 16 treatment when calculating income tax deductions on operating leases other than real property.

5. Allowing these taxpayers to follow their IFRS 16 treatment will more closely align the tax treatment with other methods of acquiring assets such as a finance lease or a debt funded outright purchase. It will also reduce compliance costs, and the possibility of inadvertent errors, from having to back out accounting expenditure and calculate a separate tax deduction.

Background

6. 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 reporting obligations, the accounting treatment was previously determined under *New Zealand Equivalent to*

1 Real property is a commonly used term that essentially relates to land and buildings.
2 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.

International Accounting Standard 17 Leases (NZ IAS 17). This standard has been replaced by IFRS 16 for years starting on or after 1 January 2019.

Accounting treatment under NZ IAS 17

7. Under NZ IAS 17, there was a difference in the accounting treatment between operating and finance leases. NZ IAS 17 defined 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.*

8. For example, a lease would be 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 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

9. 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 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.

Accounting changes moving from NZ IAS 17 to IFRS 16

10. 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.

11. Under IFRS 16, 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% discount rate:

Year	NZIAS 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

12. 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.

13. 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 Cabinet paper does not consider changes to the tax treatment of lessors.

Comment

14. The introduction of IFRS 16 provides an opportunity to more closely align the tax and accounting treatment of lessees' operating leases. I propose this be optional for all lessees that follow IFRS 16. This will achieve two main objectives:

    14.1. Efficiency - As finance leases and debt used to purchase assets are 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.

    14.2. 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 can be reduced and therefore compliance costs will be lower as will be the possibility of inadvertent error.

15. This option will only be available to taxpayers who follow IFRS 16 for accounting purposes. The calculation of expenditure under IFRS 16 is sufficiently complex that I do not recommend allowing a non-IFRS taxpayer to undertake these calculations solely for tax purposes. Instead these taxpayers, and any IFRS taxpayer who chooses not to follow their account treatment for tax purposes, should continue to follow the existing method.

Adjustments between accounting and tax

16. There are certain accounting entries required to be made under IFRS 16 that spread expenditure over the (remaining) term of the lease that should be recognised differently for tax purposes. This is because expenditure for tax purposes is typically deductible when it is incurred and allowing a deduction over the life of the lease would offer a more favourable tax treatment compared with taxpayers that do not follow IFRS 16 or have not elected to follow IFRS 16 for tax purposes.

17. The adjustments that should be made between the IFRS 16 and tax treatment are:

    17.1. Impairment, fair value and revaluation costs – these are essentially a provision against future events and for tax purposes they should be deductible when (and if) they are incurred.

    17.2. Make good costs – these are the costs of restoring an asset before it is returned to the lessor and for tax purposes should be deductible when they are incurred which is typically near or at the end of the lease.

    17.3. Direct and mobilisation costs – these are the costs of entering into a lease and for tax purposes should be deducible when they are incurred which is typically at or near the start of a lease[3]. To minimise compliance costs this adjustment should be at the option of the taxpayer.

18. The exclusion of real property leases, which is discussed further below, should significantly reduce the number of adjustments that taxpayers are required to make.

Leases that will be covered by the election

19. This election to follow the IFRS 16 treatment for tax purposes will apply only to operating leases, using the existing tax definition of operating lease. This definition achieves a similar outcome to the accounting definition, in paragraph above, with the largest difference being all leases of real property must be a tax operating lease. There are some exceptions to this, discussed below, where operating leases should continue to follow their existing treatment.

Real property

20. The election to follow the IFRS 16 treatment for tax purposes should not apply to leases of real property and they should instead continue to follow their existing tax treatment.

21. There are several reasons for this including:

    21.1. there is less efficiency benefit from this alignment as leases of real property cannot be a tax finance lease; and

3 Some direct costs are already incurred over the term of the lease. For these costs the IFRS 16 and tax treatment will already align so no further adjustment will be required.

21.2. leases of real property typically have many more accounting features, as discussed at paragraph above, that would need to be adjusted for tax purposes. By excluding real property compliance costs will be much lower and the proportion of taxpayers choosing to follow their accounting treatment for tax purposes is expected to be higher.

22. 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. Excluding real property significantly reduces the fiscal cost of the proposals.

Leasing to associated persons and sub-leasing

23. When a taxpayer has an asset they lease to an associated party this would create a tax timing benefit to those two taxpayers when considered as a group if they could follow the IFRS 16 treatment for tax.

24. This timing benefit also arises when a taxpayer leases an asset from another person and then sub-leases that asset.

25. These issues arise as IFRS 16 applies a different method to spread income for lessors and expenses for lessees.

26. To prevent this mismatch, the existing tax treatment should continue to apply if:

26.1. a taxpayer leases an asset then sub-leases it to another person; or

26.2. a taxpayer leases an asset from an associated party.

Equipment leases

27. Aside from real property, the other common high value assets subject to leases are large equipment such as aircraft. These are typically treated as tax finance leases so will not be affected by the recommendations in this paper. If high value equipment is leased under a tax operating lease by a taxpayer who has chosen to follow the IFRS 16 treatment for tax then they should also be able to follow the IFRS 16 treatment for that equipment.

Further details

28. Once a taxpayer elects to follow IFRS 16 for tax they should be required to continue this treatment in all future periods except when they cease to follow IFRS 16 for accounting purposes.

29. A taxpayer electing to follow IFRS 16 for tax will typically incur a one off deduction arising from expenditure that was not deductible under NZ IAS 17 or the former tax treatment but would have been deductible if they have been able to follow IFRS 16 in earlier periods. To minimise the upfront impact on tax revenue I recommend this deduction be spread over five years.

30. When a taxpayer ends a lease or stops applying IFRS for accounting they should calculate a wash-up to ensure total tax deductions are the same as those incurred by

a taxpayer who is not following IFRS 16 for tax. When a lease ends after following its full intended term this wash-up will typically be zero.

Consultation

31. Targeted consultation has been undertaken with affected taxpayers, representative bodies and their advisors. They are supportive of proposals to allow closer alignment of tax and accounting operating lease expenditure for lessees following IFRS.

32. The Treasury has been consulted and support the proposals.

Financial Implications

33. The fiscal impact of the changes is a revenue loss of approximately $1.8 million per year for 5 years, with a corresponding impact on the operating balance:

	$m – increase/(decrease)			
Vote Revenue **Minister of Revenue**	**2019/20**	**2020/21**	**2021/22**	**2022/23 & Outyears**
Tax Revenue	(1.800)	(1.800)	(1.800)	(1.800)
Total Operating	**(1.800)**	**(1.800)**	**(1.800)**	**(1.800)**

34. The cost of this proposal can be accounted for on the tax policy scorecard.

35. The current scorecard balance to the end of the 2022/23 fiscal year is $51.806 million. The implementation of this policy would reduce the cumulative scorecard balance to $44.606 million. There are currently no other upcoming items on the scorecard.

36. As expenditure by lessees will continue to be deductible, and these proposals only change the timing of those deductions, this proposal will have no direct effect on tax revenue after the five-year transition period ends in 2023/24.

Legislative Implications

37. Implementing these proposals will require changes to the Income Tax Act 2007. I recommend that the necessary amendments are included in the next omnibus taxation bill scheduled for introduction in early-2020 with effect from the 2019-20 income year.

Impact Analysis

38. A Regulatory Impact Assessment (RIA) is attached.

39. 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.

Human Rights

40. There are no human rights implications arising from the proposals in this paper.

Gender Implications

41. There are no gender implications arising from the proposals in this paper.

Disability Perspective

42. There are no specific disability considerations arising from the proposals in this paper.

Publicity

43. Inland Revenue will make an announcement on this policy once Cabinet decisions have been made. I will also make an announcement about the introduction of the bill which will contain this proposal. A commentary on the bill will be released at this time.

Proactive Release

44. I propose to proactively release this Cabinet paper, associated minutes, and RIA in whole within 30 working days of Cabinet making final decisions.

Recommendations

The Minister of Revenue recommends that the Committee:

1. agree that the tax treatment for lessees of operating leases that are not real property, leased from an associated party or sub-leased should be amended to follow IFRS 16 for taxpayers who choose to do so.

2. agree that taxpayers following recommendation 1 should be required to make adjustments to ensure certain operating lease expenditure continues to be tax deductible close to when it is incurred.

3. agree that expenditure arising from the transition to the IFRS 16 method for tax should be spread over five years.

4. agree that recommendation 1 to 3 should apply for the 2019-20 and later income years.

5. note that agreeing to recommendation 1 to 4 above will have an estimated revenue cost of $7.200 million over the forecast period,

	$m – increase/(decrease)			
Vote Revenue **Minister of Revenue**	**2019/20**	**2020/21**	**2021/22**	**2022/23 & Outyears**
Tax Revenue	(1.800)	(1.800)	(1.800)	(1.800)
Total Operating	**(1.800)**	**(1.800)**	**(1.800)**	**(1.800)**

6. note that the final year of fiscal impact outlined in recommendation 5 is 2023/24.

7. agree that the changes recommended above be included in the next available omnibus tax bill

Authorised for lodgement

Hon Stuart Nash

Minister of Revenue

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.

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[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.

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.

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[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.

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.

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.

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.

Cabinet Economic Development Committee

Minute of Decision

Income Tax Treatment of Leases Subject to International Financial Reporting Standards

Portfolio **Revenue**

On 13 November 2019, the Cabinet Economic Development Committee:

1 **agreed** that the tax treatment for lessees of operating leases that are not real property, leased from an associated party or sub-leased, be amended to follow International Financial Reporting Standards (IFRS 16) for taxpayers who choose to do so;

2 **agreed** that taxpayers who elect to follow IFRS 16 be required to make adjustments to ensure certain operating lease expenditure continues to be tax deductible close to when it is incurred;

3 **agreed** that expenditure arising from the transition to the IFRS 16 method for tax be spread over five years;

4 **agreed** that the proposals in paragraphs 1-3 above apply for the 2019/20 and later income years;

5 **noted** that the above proposals will have an estimated revenue cost of $7.200 million over the forecast period, as follows:

	$m – increase/(decrease)			
Vote Revenue **Minister of Revenue**	**2019/20**	**2020/21**	**2021/22**	**2022/23 & Outyears**
Tax Revenue	(1.800)	(1.800)	(1.800)	(1.800)
Total Operating	**(1.800)**	**(1.800)**	**(1.800)**	**(1.800)**

6 **noted** that the final year of fiscal impact outlined in paragraph 5 above is 2023/24;

7 **agreed** that the above changes be included in the next available omnibus tax bill.

Jack Petterson
Committee Secretary

Hard-copy distribution: (see over)

Present:
Rt Hon Winston Peters
Hon Kelvin Davis
Hon Grant Robertson (Chair)
Hon Dr Megan Woods
Hon Chris Hipkins
Hon David Parker
Hon Nanaia Mahuta
Hon Stuart Nash
Hon Iain Lees-Galloway
Hon Jenny Salesa
Hon Shane Jones
Hon Kris Faafoi
Hon Willie Jackson
Hon James Shaw
Hon Julie Anne Genter
Hon Eugenie Sage

Officials present from:
Officials Committee for DEV

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Minister of Revenue