

ADVISORY ON TAX TREATMENT OF LEASE ACCOUNTING

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Clarifying the Tax Treatment of Lease
Accounting by Lessees Under Philippine
Financial Reporting Standards

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**Tax Treatment of Lease Accounting by Lessees
Under Philippine Financial Reporting Standards**

OVERVIEW OF PFRS AND TAX TREATMENT

Particulars	PFRS		Taxation	
	General Approach ¹	Lease Exemption ²	Lease	Conditional Sale
Depreciation of Right-of-Use Asset (ROUA)	Generally recognized as expense	Not recognized	Not allowed as deduction	Depreciation of leased asset can be claimed as deduction from gross income
Interest on lease liability	Generally recognized as expense	Not recognized	Not allowed as deduction	Interest on lease liability can be claimed as deduction from gross income
Rent expense	Generally recognized as expense	Recognized on a straight-line basis over the long term	Allowed as deduction from the gross income	Not recognized
Gain/loss on lease modification	Recognized in profit or loss at the time of modification	Not recognized but may affect the amount of rent expense to be recognized in subsequent period/s	Not included in the determination of taxable income	Does not apply to leases that qualify as conditional sale

¹ Recognizes the ROUA

² Option not to recognize lease as ROUA

Particulars	PFRS		Taxation	
	General Approach ¹	Lease Exemption ²	Lease	Conditional Sale
Initial direct costs paid/incurred by lessee	These are included in determining the cost of the ROUA	Recognized as an outright expense	Recognized as an outright expense during the period that the same is accrued or paid	Recognized as an outright expense during the period that the same is accrued or paid

DETAILED PFRS TREATMENT

	Treatment
Initial recognition	<p>At commencement, all lessees recognize: (i) a ROUA; and (ii) a lease liability</p> <p>Exceptions (under PFRS 16):</p> <ul style="list-style-type: none"> <input checked="" type="checkbox"/> Short-term lease³ <input checked="" type="checkbox"/> Lease of low-value asset recognition⁴
Initial measurement	<p>Lease liability – Measured at:</p> <ul style="list-style-type: none"> <input checked="" type="checkbox"/> If rate can be readily determined – at the present value of the future lease payments discounted using the interest rate implicit in the lease; or <input checked="" type="checkbox"/> If the rate cannot be readily determined – lessee shall use its incremental borrowing rate. <p>ROUA – At the amount of lease liability adjusted for:</p> <ul style="list-style-type: none"> <input checked="" type="checkbox"/> Payments made to the lessor at or before the commencement of the lease; <input checked="" type="checkbox"/> Initial direct costs incurred by lessee; and <input checked="" type="checkbox"/> Estimate of any decommissioning costs.

³ Lease term is 12 months or less

⁴ Underlying asset is of low value (USD5,000.00 per standard)

	Treatment
Subsequent measurement	<p>Lease liability – Carrying amount is increased by the interest on the lease liability and is reduced by the lease payments</p> <p>ROUA – Cost less accumulated depreciation and accumulated impairment losses</p> <p>Depreciation of ROUA – Recognized in profit or loss unless permitted to be capitalized under other PFRS</p> <p><i>Note: If depreciation of ROUA is on a straight-line basis, the total periodic expense (i.e. sum of interest expense and depreciation expense) is generally higher in the early periods and lower in the later periods</i></p>
Lease modification	<p>If it does not decrease the scope of a lease – Requires recalculation of the lease liability with a corresponding adjustment to the ROUA but will not normally result in any gain or loss in the statement of income</p> <p>If it decreases the scope of a lease – Requires partial derecognition of ROUA and lease liability wherein the difference between the amounts of reduction in the ROUA and lease liability is recognized in profit or loss</p>
Lease exemption	<p>ROUA and lease liability is not recognized in the statements of financial position</p> <p>Lease payments are recognized as expense</p>

DETAILED TAX TREATMENT

Income Tax Implications

	Treatment
Depreciation on ROUA and interest expense on lease liability	Not treated as deductible expense Only the actual amount of rent paid/incurred (including other payments to lessors) shall be allowed as deductions
Initial direct costs ⁵ paid by the lessee	Claimed as expense in the year it was paid/incurred subject to substantiation and withholding requirements ⁶
Expenses paid/incurred by lessee for the account of the lessor	Claimed as expense in the year it was paid/incurred; Provided, that the lessor shall issue invoices/receipts in the name of the lessee
Short-term lease and low-value assets	Accounted as operating lease (Only the actual amount of rent paid/incurred shall be allowed as deductions)
Gains/losses from lease modifications	Not included in the determination of taxable income
Security deposits	In general, recorded as asset in the year the advance deposit was received; however, if the conditions occur which make the security deposit the property of the lessor, the lessee shall be entitled to a deduction of the amount of security deposit applied
Restoration costs	Claimed as expense in the year it was paid/incurred

⁵ Payments which are directly related to the negotiation and execution of a lease agreement

⁶ **Comment:** Under the Ease of Paying Taxes (EOPT) Act, withholding of taxes is no longer a requirement for deductibility of expenses.

Business Tax Implications

- ☑ Input VAT shall only be creditable upon payment of rentals which shall be evidenced by a VAT Official Receipt⁷.
- ☑ For conditional sales, the rules on installment sale of real property shall apply;
 - If the initial payment during the year of sale exceeds 25% of the gross selling price, the same shall be considered a cash sale which makes the entire selling price taxable in the year of sale;
 - For installment sales where the initial payments do not exceed 25% of the gross selling price, VAT shall be recognized on the installment payments (including interest and penalties), actually and/or constructively received by the seller; and
 - Lessee/buyer can only claim the input tax in the same period as the lessor/seller recognized the output tax.

Withholding Tax Implications

- ☑ Only the actual rental paid or accrued shall be considered as the tax base for EWT purposes⁸, without regard to the depreciation expense from the ROUA.
- ☑ For conditional sale of personal property, it shall be treated as a sale of goods and will be subject to the following:
 - 1% EWT on income payments made by top withholding agents; and
 - 15% EWT on interest income from any debt instruments not within the coverage of deposit substitutes.
- ☑ For conditional sale of personal property, it is either exempt from or subject to the graduated EWT rate under Section 2.57.2(F) of RR No. 2-98, as amended.

Documentary Stamp Tax Implications

Type of Lease	Treatment
Finance lease	Subject to DST on debt instruments
Operating lease	Subject to DST on lease agreements

⁷ **Comment:** Under the EOPT Act, actual payment of purchase of services/lease of properties is no longer required to recognize input VAT. Mere accrual is sufficient. Also, sales/commercial invoices shall be the sole proof of purchase of goods/services or lease of properties.

⁸ **Comment:** Under the EOPT Act, the obligation to withhold arises at the time the income has become payable.

Operating Leases vs. Finance Leases

	Operating Lease	Finance Lease
Definition	<p>A contract under which:</p> <ul style="list-style-type: none"> ☑ the asset is not wholly amortized during the primary period of the lease; and ☑ the lessor does not rely solely on the rentals during the primary period for his profits, but looks for the recovery of the balance of his costs and for the rest of his profits from the sale or re-lease of the returned asset of the primary lease period 	<p>A contract involving payment over an obligatory period⁹ of specified rental amounts for the use of a lessor's property, sufficient in total to amortize the capital outlay of the lessor and to provide for the lessor's borrowing costs and profits.</p> <p>Lessee exercises the choice of the asset and is responsible for maintenance and other costs.</p> <p>Residual value shall not be less than 5% of the lessor's acquisition cost of the leased asset.</p>
Income Tax Treatment	<p>Lessee may deduct the amount of rent paid/accrued (including all expenses paid to or for the account of the lessor)</p> <p>Advance rentals are apportioned or applied over the lease term</p>	<p>Same with operating lease, except that:</p> <ul style="list-style-type: none"> ☑ depreciation may be recognized during the primary lease period (but such period shall not be less than 60% of the depreciable life); and ☑ interest expense are not accounted for separately from the principal payments

⁹ It refers to the primary or basic non-cancellable period of the lease which in no case shall be less than 730 days. The period may be extended by non-cancellable periods with rentals significantly reduced.

Conditional Sales

A lease contract shall be treated as conditional sales contract is one or more of the following **compelling persuasive facts** are present:

- lessee is given the option to purchase the asset at anytime during the obligatory period of the lease;
- lessee acquires automatic ownership of the asset upon payment of the "rentals";
- Portions of the periodic rental payments are credited to the purchase price of the asset; and/or
- Receipts indicate that the payments were for partial or full payment of the asset.

In the absence of the above, intent to treat the transaction as a purchase/sale rather than a lease/rental may be said to exist if one or more of the following conditions are present:

- Portions of the periodic payments are made specifically to an equity to be acquired by the lessee; and/or
- Property may be acquired under a purchase option at a nominal or relatively small amount.

Source:

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