GENERAL

This Practice Note sets out the current Zambia Revenue Authority (ZRA) view on the normal accountancy and taxation treatment of leasing transactions in connection with the acquisition of fixed assets.

The contents of the Practice Note are for general guidance only and should not be regarded as binding on ZRA or the taxpayer. The Practice Note does not affect person's right of appeal or preclude any discretionary or concessionary treatment.

Enquiries may be made at the nearest ZRA office, Direct Tax Division.

References, unless otherwise stated, are to the Income Tax Act (ITA), CAP 323 Laws of Zambia.

COMMISSIONER – GENERAL

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1.0 INTRODUCTION

1.1 Commercial background

All leasing involves a contract between a lessor and a lessee giving the lessee possession and use of an asset on payment of rentals or other consideration. But, within this common principle, there are a number of different types of lease structure. The most significant distinction is between an operating lease and a finance lease.

1.2 Operating lease

In practical terms, an operating lease is the kind of lease a person has when he hires an asset for a period shorter than its likely useful life. Most typically, a person who hires a
C vehicle for a week is taking out an operating lease.

In hiring an asset under such a lease the lessee normally takes on few of the risks and rewards of ownership of the asset. It is the lessor who stands to gain or lose from the speed the asset depreciates. The lessor usually retains responsibility for at least some of the running costs associated with the leased asset. The typical operating lessor will be a manufacturer or dealer in the assets in question.

1.3 Nature of finance lease

A finance lease, by contrast, is in economic substance very close to a loan to purchase an asset, secured on that asset. Hence, finance lessors are often members of banking groups. The lease rentals are calculated to ensure that the lessor recoups an amount equal to its capital outlay in purchasing the asset plus interest at a rate sufficient to ensure a profit after deducting its own costs of raising finance. The insurance and running costs of the
C asset are borne by the lessee. So is the depreciation risk.

1.4 Finance lease rentals

As a matter of law, the payments made under a finance lease are rental payments for the hire of the asset. This basic point must not be overlooked although, in practice, it may be convenient to focus on the substance and analyse the rentals between:

- .the 'interest' or 'finance charge' element; and .
- the 'capital' or 'loan repayment' element.

Finance leasing is frequently adopted as a means of funding capital investment. It is especially attractive to businesses which, for whatever reason, are 'tax-exhausted', that is the lessee cannot utilise the capital allowances available on the asset in question, because of, say, the presence of losses or the lessee is anon-taxpayer.

1.5 Assets leased

Finance leases are most commonly associated with ~he funding of machinery and plant. However, assets which are not machinery and plant can be finance leased and so can buildings and structures; that is, a landlord may grant a lease on terms which are essentially the

1.7 Rebates

In addition, at any time from the end of the primary period (and sometimes from an earlier point) the lessee is generally entitled to require the lessor to sell the asset and pay the proceeds to the lessee by way of rental rebate. The asset is, in substance, the lessee's property and so the lessee wants the sale proceeds. However, the lessor is sometimes entitled to retain a small proportion, say 5 per cent, of the proceeds. In addition to this retention the lessor is also entitled to ensure that, if the need arises, it recoups its capital investment plus interest on the outlay either out of the sale proceeds or by way of a further 'termination rental'. The parties must be careful to avoid any provision that gives
C the lessee the right to acquire the asset because, in that case, para.lO(l) of the 5th schedule to the Income Tax Act will shift the title to capital allowances from lessor to
lessee.

1.8 Rental profiles

The commercial circumstances of the parties, and sometimes tax considerations, will determine the profile of rentals in the primary period. While flat rate rentals are payable under the majority of finance leases there are many cases where the rental profile is skewed in some way.

1.9 Front-end loading

The first or earliest rental payments may often be significantly greater than subsequent payments within the primary period. This is often the case where a finance leased asset is replaced by another under a new lease. The rental rebate due to the lessee under the old lease is used to satisfy, in whole or in part, the initial rental payable un~r the new lease.

1.10 Hire purchase and finance leasing -distinction.

A hire purchase contract is a type of finance lease where the user has the option to purchase the asset at the end of the hire period, usually for a nominal sum. In terms of economic effects there is little difference between a hire purchase contract and an ordinary finance lease. In both cases the user of the asset enjoys the risks and rewards of
ownership. But the distinction between the two has significant tax consequences. Thus for capital allowance purposes:

.the finance lessor gets the allowances, not the finance lessee;

.the hire purchase lessee gets the allowances, not the hire purchase lessor C (Para 10(1), sch 5 ITA).

The parties will usually choose whether or not to include an option to buy to maximise the use of the available capital allowances.

2.0 ACCOUNTANCY TREATMENT 2.1 SSAP 21

The accountancy treatment of operating and finance leases (including hire purchase contracts) is dealt with by Statement of Standard Accounting Practice 21. Standard Statements of Accounting Practice were issued by the Accounting Standards Committee of the major UK accounting bodies and accounts presented to ZRA will probably be prepared in

An operating lease is defined residually as any lease which is not a finance lease. 2.3 Accounting borderline

2.3 Accounting borderline

There is an element of judgement involved in arriving at the present value of the lease payments and sometimes the accounts treatment can be influenced by the result desired trader; *for* example, a lessee may be keen to get the lease 'off balance sheet' in the hope of making the financial position of the business look better. The lessor and lessee may even exercise their judgement differently, so that one treats the deal as a finance lease (on balance sheet) and the other treats it as an operating lease (off balance sheet). However, a new *UK* accounting standard (Financial Reporting Standard 5 -see 2.11, below) attempts to reduce the scope *for* manipulatit>n by insisting that the parties take account of the substance of the deal.

2.4 SSAP 21 treatment of finance lease

Under SSAP 21 the treatment of a finance lease *for* accountancy purposes follows the economic substance of the transaction rather than the legal *form.* The transaction is not treated as the hiring of an asset. Instead the lessor is regarded as making a loan at interest to the lessee to fund the lessee's acquisition of the asset in question. The standard has no effect on the title to capital allowances (which depends on the legal ownership) but, as will be seen, the staridard is relevant in computing the revenue deductions due to the
C" lessee.

2.5 SSAP 21 treatment of lessors

The finance lessor does not show the asset in his balance sheet even though, as a matter of law, he owns it. Instead, the finance lessor's outlay in purchasing the leased asset is shown in its balance sheet simply as a loan to the lessee. The rentals receivable are split into two streams. One stream is a 'capital' element going to repay the loan; the other is a finance charge (that is, in substance, the interest on the loan) which is credited to the
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profit and loss account as income. This is usually achieved by crediting the gross rentals i receivable to the lessor's profit and loss account and then by charging the 'capital' ; I element, which reduces the loan outstanding, against profits. This charge to the profit and loss account is described as 'depreciation'. Obviously, the finance's lessor's commercial profit (as in the case of any lender) is merely the 'interest' on the 'loan'.

2.6 SSAP 21 treatment of lessees

The treatment of the transaction in the accounts of the lessee is complementary to this. The lessee is in effect regarded as having purchased the asset with the assistance of a loan *from* the lessor. The cost of the asset is therefore shown in the lessee's balance sheet. It is depreciated by writing off the cost less residual value over the shorter of:

- .the lease term, including any secondary period when it is reasonably certain that the lease will not be terminated beforehand,
- and .the useful life of the asset.

The balance sheet will also show as a liability what is in effect the loan from the lessor.

is represented by finance charges is that the lessor's return (akin to interest) on its investment should be a constant percentage of the sums outstanding under the lease.

2.9 Profile of finance charge element

The profile of finance charges over the term of a finance lease where the rental payments 0in the primary period are constant will be similar to the interest elemen~ in repayments of an ordinary domestic mortgage loan. At first, most of the rentals will be the finance charge (interest in substance) and very little will be capital repayment. The finance charge element as a proportion of each rental will fall over the primary period until most of the rental is capital repayment and very little is finance charge.

2.10 Methods of calculating finance charge in use

Several methods of calculating the finance charge in each rental are used. They vary in their degree of sophistication and are described in more details in the Guidance Notes on SSAP 21 prepared by the Accounting Standards Committee.

2.11 FRS 5

Under Financial Reporting Standard No 5 leases which fall just outside the definition of a finance lease under SSAP 21 may be treated as if they were finance leases.

2.12 Operating lease -accounting treatment

By contrast to the treatment of a finance lease the commercial treatment of an operating lease under SSAP 21 is straightforward. In economic substance, as well as legal form, such a lease normally involves the simple hiring of an asset. Rentals should be charged (and recognised as the income of the lessee) on a straight-line basis over the lease term unless another systematic and rational basis is more appropriate.

3.0 FINANCE LEASING: TAX TREATMENT

3.1 Basic principles

As explained above, a finance leasing transaction is accounted for essentially as if it were the making of a loan to fund the purchase of the asset concerned. For tax purposes, however, a finance lease -in accordance with the legal form of th~ transaction -is

regarded as the hiring of an asset unless, in the case of machinery and plant, there is an option for the lessee to buy the asset-. Thus:

- whatever machinery and plant allowances are due go to the legal owner of the asset, the lessor, unless there is a purchase option in a lease, in which case the allowances go the hire purchase lessee .
- rentals are wholly revenue items -no part is regarded as the repayment of a loan;
- rentals should be allocated to periods of account in a manner consistent with the fundamental accruals concept of commercial accountancy;

lease instead. although again the mechanism is different. This time there are no capital allowances (the trader does not own the asset) but he gets revenue deductions for the lease rentals which, in total, equal the interest and the loan.

In Zambia, because the normal primary period is short -two years maximum at present - there is little tax incentive for financial institutions to finance non-agricultural,
C manufacturing or tourism assets by way of lease as the lessor will only get tax relief for ,.' the cost of the asset over four years through capital allowances at 25% on a straight line basis. In the case of assets used wholly for farming, manufacture or tourism the availability of accelerated capital allowances at 50% make finance leasing more attractive. V A T is payable on lease rentals and this is a further factor in the lease/loan equation.

3.3 Finance lease or Hire Purchase?

Before accepting that an arrangement to hire assets is in fact a finance lease Inspectors should bear in mind the possibility that if the agreement provides for legal ownership of the asset to pass to the hirer or gives the hirer an option at any point to purchase the asset concerned, the arrangement should be regarded as a hire purchase contract.

3.4 Operating and finance leases

On the other hand, Inspectors will not normally find it cost-effective to spend time exploring whether an agreement satisfies the accounting definition of a finance lease (or is to be treated as if it were a finance lease under FRS 5) as against an operating lease. In either case the tax treatment is to allocate rentals to periods of account in accordance with the accruals concept and the timing differences that may arise from the way a lease is classified are likely to be small.

3.5 Accruals concept .

Finance lease rentals are revenue outgoings which should be allocated to periods of account in accordance with commercial accounting principles. In particular, they should be allocated in a manner consistent with the fundamental 'accruals' concept (as set out in SSAP 2). Under the matching leg of that concept expenditure should be set against the income it can be assumed to generate.

<u>Rentals should be snread be}:ond the nrimaa neriod of the lease where that neriod is shorter than the useful economic life of the asset.</u> This approach is in response to the fact that most leases in Zambia will have a primary period of two years or less which
0 is likely to be much shorter than the useful life of the asset concerned. The effect of the previous practice of allowing the full rentals as paid was to give relief for the rentals over a much shorter period than that over which the business enjoyed the benefits to be derived from the leased asset. This is contrary to the accruals concept.

3.6 Use ofSSAP 21

Where SSAP 21 has been correctly applied in a finance lessee's accounts no adjustments will nomially be necessary in the tax computation to give a deduction in the appropriate periods and in accordance with the accruals concept, for total rentals payable net of rebates. That is, correctly prepared accounts normally give the right answer for tax purposes without further action in the tax computation. The obvious compliance issue which arises is whether correct accountancy principles have been applied or whether, in an attempt to accelerate tax relief,

3.7 SSAP 21 correctly applied -approach to computation

The total of the depreciation charged in respect of the leased asset, adjusted for any profit or loss on sale, is equal to the total rentals paid less the finance charge element (charged against profits separately) and adjusted for rebates (or sometimes additional rental
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payments) on termination of the lease.

Since the depreciation charge also measures the rate at which the value the business extracts from the leased asset is used up the result is at the same time to give a tax deduction consistent with the accruals concept.

3.8 Case law .

The use of SSAPs 2 and 21 in this way was approved by the UK Court of Appeal in the case of Threlfall v Jones (66 T.C. 77). It contains no concessional element. In particular it involves no deduction for depreciation as such. The allowance of the depreciation charge is simply a means of ensuring that rentals are deducted for tax purposes in a manner consistent with the accruals concept.

3.9 Allocation of finance charge

There are a number of commercially ac.ceptable methods of allocating the total finance charge element of rentals to each perlod of account for the purposes of SSAP 21. Inspectors will normally accept any method used in the accounts which seems broadly consistent with the intention to allocate finance charges in such a way as to give a constant return to the lessor on the total rentals outstanding.

3.10 Termination adjustments -general

A finance lease will normally contain provisions whereby, when the lease comes to an end, the lessee receives a rental rebate (or sometimes pays a further sum) by reference to -'; the value of the asset at that point. This adjustment reflects the fact that under the lease the risks and rewards of ownership (though not of course legal title) substantially lie with the lessee.

3.11 Calculation of tax adjustment

To the extent that these sums are in essence adjustments of past revenue outgoings they are on revenue account and should be taken into account in the computation of trading profits for the period in which they are recognised in the lessee's accounts under correct accounting practice. But this is subject to the proviso that the sum taken into account in this way should be such as to ensure that over the life of the lease deductions are made for the aggregate rentals paid (net of any rebate but including any supplementary rental). Thus, where the total rentals paid are different from the rentals so far allowed for tax, the sum paid or received on termination will have to be adjusted for tax purposes to achieve that result. This approach applies whether the lease is brought to an end at the conclusion of its full term, at the end of its primary period or at an earlier point.

3.13 Premature terminations .

On premature termination of a finance lease payments may occasionally be made which are not in the nature of adjustments to past rentals but rather represent a charge imposed on the lessee as consideration for being freed early from his obligations under the lease. Where the assets leased are used as capital assets in the lessee's business the lease itself is such a capital asset and an exit charge of this kind would be capital. Whether a payment is an adjustment of past rentals or a charge of this kind will depend on the facts of individual cases.

0 4. FINANCE LESSORS

4.1 Timing of lease rentals receivable -general.

In contrast to the position for finance lessees it is not possible to derive from SSAP 21 a comprehensive method of allocating rentals to periods of account in computing the lessor's profits. This is because there are no accounting entries, equivalent to the depreciation of the leased asset in the lessee's accounts, to give a means of allocating the non- finance charge element of rentals for this purpose. In particular, the treatment of that element as a repayment of what is regarded as a loan to the lessee (complementing the treatment of the lessee under SSAP 21) does not necessarily bear a direct relationship to the rate at which the lessor enjoys economic benefits under the lease.

4.2 Timing of lease rentals -receivable -particular points.

The following points should be borne in mind in connection with the timing of a finance 0 lessor's rental income:

- there is no principle of tax law which requires symmetry between lessor and lessee in the timing of rentals;

- .in particular, since normally the lessor's economic stake in the transaction virtually comes to an end at the conclusion of the primary period of the lease the rentals should all be recognised over that period; this is the case even if the lessee's rental payments would be recognised over a longer period;

- even when rentals are recognised by the lessor over the primary period Inspectors should still examine critically any treatment of rental income for tax purposes which has the effect of deferring the recognition of the finance charge element of rentals to a period later than that in which it is recognised in accounts drawn up under SSAP 21. (This is because the finance charge element of rentals is treated as income both under SSAP 21 and for tax purposes and in principle the timing of items for tax purposes / normally follows that in the commercial accounts); I

- whatever method of recognizing rental income for tax purposes is in use should be applied to all finance leases written by the same lessor and by connected lessors, especially other leasing companies in the same group

- .Inspectors should consider carefully the consequences of changes of timing before seeking to disturb a settled method of recognizing rentals; in particular it would not normally be possible to insist that a revised method is applied to new leases while the