

IFRS® Interpretations Committee meeting

Project	Non-refundable value-added tax on lease payments (IFRS 16)		
Paper topic	Initial consideration		
CONTACT(S)	Gustavo Olinda	golinda@ifrs.org	+44 (0) 20 7246 6481

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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about how a lessee accounts for any non-refundable value-added tax (VAT) charged on lease payments.
2. This paper:
 - (a) provides the Committee with a summary of the matter;
 - (b) presents our research and analysis; and
 - (c) asks the Committee whether it agrees with our recommendation not to add a standard-setting project to the work plan.

Structure of the paper

3. This paper includes the following:
 - (a) background information;
 - (b) summary of outreach;
 - (c) staff analysis; and
 - (d) staff recommendation.

4. There are two appendices to the paper:
 - (a) Appendix A—proposed wording of the tentative agenda decision; and
 - (b) Appendix B—submission.

Background information

5. The submission asks how a lessee accounts for any non-refundable VAT charged on lease payments. In the fact pattern described in the submission:
 - (a) the lessee operates in a jurisdiction in which VAT is charged on goods and services. Sellers include VAT in invoices for payment issued to a purchaser. In the case of leases, VAT is charged when invoices for payment are issued by a lessor to a lessee.
 - (b) the applicable legislation:
 - (i) requires sellers to collect VAT and remit those amounts to the government; and
 - (ii) generally allows purchasers to recover from the government VAT charged on payments for goods or services, including leases.
 - (c) because of the nature of its operations, the lessee can recover only a portion of the VAT charged on purchased goods or services. This includes VAT charged on payments it makes for leases. Consequently, a portion of the VAT the lessee pays is non-refundable.
 - (d) lease agreements require the lessee to make payments to the lessor that include amounts related to VAT charged in accordance with the applicable legislation.
6. The submitter asks whether, applying IFRS 16 *Leases*, the lessee includes non-refundable VAT as part of the lease payments for a lease.
7. Appendix B to this paper reproduces the submission, which provides further details about the alternative views identified by the submitter.

Summary of outreach

8. We sent information requests to members of the International Forum of Accounting Standard-Setters, securities regulators, and large accounting firms. The submission was also made available on our website.
9. The request asked those participating to provide information about the following:
 - (a) whether fact patterns such as the one described in paragraph 5 are common—in other words, situations in which VAT is charged on lease payments and a lessee is unable to recover all or a portion of the VAT?
 - (b) if common, is the non-refundable portion of VAT payments material for entities? If it is material:
 - (i) in which jurisdictions and industries, and for which types of assets, are fact patterns common?
 - (ii) for what reason is an entity unable to recover VAT?
 - (iii) do entities include non-refundable VAT as part of the lease payments for a lease or exclude those amounts from lease payments?
 - (c) how do entities account for the non-refundable portion of VAT on other goods or services—for example, is it included as part of the cost of the related good or service or is it recognised as a separate operating expense in the period in which it is incurred?
10. We received 17 responses—eight from national standard-setters, six from large accounting firms and three from securities regulators or organisations representing a group of securities regulators. The views received represent informal opinions and do not reflect the official views of those respondents or their organisations.

Findings from outreach

Are fact patterns common?

11. Almost all respondents said fact patterns such as the one described in paragraph 5 are common. Respondents said they observed similar fact patterns in many jurisdictions,

including Australia, Austria, Canada, China, France, Germany, Hong Kong, India, Israel, Japan, Malaysia, Netherlands, Saudi Arabia, South Africa and the UK.

12. Most respondents said these fact patterns occur mainly for entities operating in the financial sector, such as banks and insurance companies. A few respondents said similar fact patterns also occur in the health care, education and real estate sectors.
13. Respondents said the applicable legislation often does not allow entities to fully recover VAT charged on purchased goods or services (including leases) if some of the goods or services the entity sells are not subject to VAT. For example, in some jurisdictions, banks are unable to recover a portion of the VAT charged on purchased goods or services because some of their primary sources of revenue (for example, interest revenue) are not subject to VAT.
14. Respondents said the applicable legislation also may not allow entities to fully recover VAT charged on some leases depending on the nature and intended use of the underlying asset—for example, leased vehicles used by employees when the employee can use the vehicle for private purposes.
15. A few respondents said, in some jurisdictions, VAT is charged in full at lease commencement rather than at the time the lessor issues invoices for payment to the lessee—for example, when the contract is deemed a finance lease for tax purposes.

Is the non-refundable portion of VAT payments material?

16. Responses were mixed regarding the materiality of non-refundable VAT for affected lessees. Some respondents said non-refundable VAT is generally not material while some said it is material. A few respondents said it can be material in some circumstances.

Do lessees include (or exclude) non-refundable VAT on lease payments?

17. Almost all respondents said lessees do not—or generally do not—include non-refundable VAT as part of lease payments. A few respondents said they are aware of specific cases in which a lessee included non-refundable VAT as part of lease payments. One respondent said there is diversity in the way entities account for non-refundable VAT on lease payments.

18. Most respondents said, in their view, VAT payments (whether refundable or non-refundable) do not meet the definition of lease payments because they are not payments to the lessor in exchange for the right to use the underlying asset.¹ Rather, they are payments imposed by the government on the lessee; the lessor acts only as a collecting agent for the government. These respondents say non-refundable VAT is in the scope of IFRIC 21 *Levies*.
19. A few respondents said:
- (a) the accounting depends on whether, in accordance with the applicable legislation, the primary obligor for VAT is the lessee or the lessor. The lessee typically is the primary obligor, in which case it applies the accounting described in paragraph 18 above. However, when the lessor is the primary obligor, the lessee would include non-refundable VAT as part of lease payments.
 - (b) even if a lessee concludes that non-refundable VAT is part of the payments for a lease, that lessee would then determine whether the non-refundable VAT is a variable lease payment excluded from the measurement of the lease liability.

How do entities account for non-refundable VAT on other goods or services?

20. Only a few respondents provided responses to this question, saying:
- (a) for purchased services, entities generally recognise non-refundable VAT as an expense as incurred applying IFRIC 21; and
 - (b) for purchased goods, entities generally recognise non-refundable VAT as part of the cost of the asset applying the applicable IFRS Standard, such as IAS 16 *Property, Plant and Equipment* or IAS 2 *Inventories*.²

¹ IFRS 16 defines lease payments as ‘payments made by a lessee to a lessor relating to the right to use an underlying asset...’.

² Paragraph 16(a) of IAS 16 includes ‘non-refundable purchase taxes’ as an element of the cost of an item of property, plant and equipment and paragraph 11 of IAS 2 states that the cost of purchase of inventories include ‘other taxes (other than those subsequently recoverable by the entity from the taxing authorities)’.

Staff analysis

Should the Committee add a standard setting project to the work plan?

Is the matter widespread and expected to have a material effect?

21. Paragraph 5.16 of the *Due Process Handbook* sets out the criteria the Committee considers when determining whether to add a standard-setting project to the work plan. One such criterion, included in sub-paragraph 5.16(a), is that ‘the matter has widespread effect and has, or is expected to have, a material effect on those affected’.
22. The results from the outreach (see paragraphs 11–20 of this paper) indicate that fact patterns in which a lessee is unable to recover some of the VAT charged on lease payments are common in several jurisdictions. However, these results also:
 - (a) provide limited evidence that non-refundable VAT on lease payments is material for affected lessees; and
 - (b) indicate there is little diversity in the way lessees account for non-refundable VAT on lease payments.
23. Further, we note that:
 - (a) although outreach indicates that fact patterns such as the one described in this paper are common in many jurisdictions, differences in the applicable legislation in each jurisdiction could affect the accounting applied.³ In our view, the Committee would be unable to address the question without identifying a more specific fact pattern, which in turn would be less common.
 - (b) there may be little difference in the accounting that lessees apply if they conclude that non-refundable VAT is (i) a variable lease payment that is excluded from the measurement of the lease liability, or (ii) a levy within the scope of IFRIC 21. In both cases, a lessee would exclude non-refundable VAT from the measurement of the lease liability.⁴

³ For example, the applicable legislation may differ as to which party is the primary obligor for the payment of VAT and to what extent payments of non-refundable VAT are fixed or variable (as described in IFRS 16).

⁴ Differences would arise between the accounting described in paragraph 23(b) of this paper and the accounting a lessee applies if it concludes that non-refundable VAT is a fixed (or in-substance fixed) lease payment or a variable lease payment that depends on an index or rate.

24. In our view, there is insufficient evidence to suggest that the matter described in the submission has ‘widespread effect and has, or is expected to have, a material effect on those affected’ and, therefore, that it would satisfy the criterion in paragraph 5.16(a) of the *Due Process Handbook*. For this reason, we recommend that the Committee does not undertake further work at this stage and does not add a standard-setting project to the work plan to address the matter. Instead, we recommend publishing a tentative agenda decision that explains the reasons for not adding a standard-setting project to the work plan.

Staff recommendation

25. Based on our assessment of the work plan criteria in paragraph 5.16 of the *Due Process Handbook* (discussed in paragraphs 21–24 of this paper), we recommend that the Committee does not add a standard-setting project to the work plan. Instead, we recommend publishing a tentative agenda decision that explains the reasons the Committee decided not to add a standard-setting project.
26. Appendix A to this paper sets out the proposed wording of the tentative agenda decision.

Questions 1 and 2 for the Committee

1. Does the Committee agree with our recommendation not to add a standard-setting project to the work plan?
2. Does the Committee have any comments on the proposed wording of the tentative agenda decision set out in Appendix A to this paper?

Appendix A—proposed wording of the tentative agenda decision

Non-refundable value-added tax on lease payments (IFRS 16 *Leases*)

The Committee received a request asking how a lessee accounts for any non-refundable value-added tax (VAT) charged on lease payments. In the fact pattern described in the request:

- a. the lessee operates in a jurisdiction in which VAT is charged on goods and services. Sellers include VAT in invoices for payment issued to a purchaser. In the case of leases, VAT is charged when invoices for payment are issued by a lessor to a lessee.
- b. the applicable legislation:
 - i. requires sellers to collect VAT and remit those amounts to the government; and
 - ii. generally allows purchasers to recover from the government VAT charged on payments for goods or services, including leases.
- c. because of the nature of its operations, the lessee can recover only a portion of the VAT charged on purchased goods or services. This includes VAT charged on payments it makes for leases. Consequently, a portion of the VAT the lessee pays is non-refundable.
- d. lease agreements require the lessee to make payments to the lessor that include amounts related to VAT charged in accordance with the applicable legislation.

The request asked whether, applying IFRS 16 *Leases*, the lessee includes non-refundable VAT as part of the lease payments for a lease.

Research conducted by the Committee provided limited evidence that non-refundable VAT on lease payments is material for lessees affected. Further, the research indicated that there is little diversity in the way lessees account for non-refundable VAT on lease payments.

The Committee has therefore not obtained evidence that the matter has widespread effect and has, or is expected to have, a material effect on those affected. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

Appendix B—submission

B1. We have reproduced the submission below, and in doing so deleted details that would identify the submitter of this request.

Interpretation issue

IFRS 16 *Leases* (IFRS 16) does not provide clear guidance with regard to the accounting treatment of the non-refundable portion of Value-Added-Tax (i.e. the absorbed portion) relating to lease payments and whether this should be capitalised on initial recognition and measurement of the lease liability and right-of-use (ROU) asset by a lessee. Value-Added-Tax (VAT), also known in some jurisdictions as Goods and Services Tax (GST), is a type of tax that is assessed incrementally, based on the increase in the value of a product or service at each stage of production or distribution. VAT essentially compensates for the shared services and infrastructure provided in certain countries and funded by its taxpayers that were utilised in the elaboration of that product or service. Not all countries require VAT to be charged on all goods and/or services.

The overall principle of IFRS 16 is to achieve the same presentation for assets leased as for assets purchased. IFRS 16 requires a ROU asset to be measured at cost and the lease liability to be measured at the present value of lease payments. However, IFRS 16 does not provide explicit guidance on whether or not to include or exclude the non-refundable portion (absorbed) VAT portion of the lease payments when measuring the lease liability.

Paragraphs of IFRS guidance

IFRS 16 Extracts

Paragraph 15 provides that: *“As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component.”*

Paragraph 23 states that: *“At the commencement date, a lessee shall measure the right-of-use asset at cost.”*

Paragraph 24 explains that: *“The cost of the right-of-use asset shall comprise:*

- a) the amount of the initial measurement of the lease liability, as described in paragraph 26;*
- b) any lease payments made at or before the commencement date, less any lease incentives received;*
- c) any initial direct costs incurred by the lessee; and*
- d) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.”*

Paragraph 26 states that: *“At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be*

readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate."

Paragraph 27 explains that: *"At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:*

- a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives receivable;*
- b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date (as described in paragraph 28);*
- c) amounts expected to be payable by the lessee under residual value guarantees;*
- d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraphs B37–B40); and*
- e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease."*

Paragraph 28 further states that: *"Variable lease payments that depend on an index or a rate described in paragraph 27(b) include, for example, payments linked to a consumer price index, payments linked to a benchmark interest rate (such as LIBOR) or payments that vary to reflect changes in market rental rates."*

Appendix A of IFRS 16 provides the following relevant definitions:

- *the 'fixed payments' component of lease payments is defined as: "Payments made by a lessee to a lessor for the right to use an underlying asset during the lease term, excluding variable lease payments."*
- *'initial direct costs' is defined as: "Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease."*
- *'lease payments' is defined as: "Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:*
 - a) fixed payments (including in-substance fixed payments), less any lease incentives;*
 - b) variable lease payments that depend on an index or a rate;*
 - c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and*
 - d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.*

For the lessee, lease payments also include amounts expected to be payable by the lessee under residual value guarantees. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.

For the lessor, lease payments also include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. Lease payments do not include payments allocated to non-lease components."

- *'variable lease payments' is defined as: "The portion of payments made by a lessee to a lessor for the right to use an underlying asset during the lease term that varies because of changes in facts or circumstances occurring after the commencement date, other than the passage of time."*

Furthermore, Appendix C of IFRS 16, paragraph C10(d) provides the following practical expedient upon transition to the Standard to leases previously classified as operating leases

applying IAS 17 (the practical expedient is permitted to be applied on a lease-by-lease basis):
“A lessee may exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.”

In the Basis for Conclusions, IFRS 16 paragraph BC53 states that: *“Consequently, the IASB decided to require a single lessee accounting model for all leases recognised in a lessee’s balance sheet. This model requires a lessee to depreciate the right-of-use asset similarly to other non-financial assets and to account for the lease liability similarly to other financial liabilities.”*

Extracts from IAS 16 Property, Plant and Equipment (IAS 16)

IAS 16 paragraph 6 defines cost as *“the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs.”*

IAS 16 paragraph 15 requires the following: *“An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.”*

Paragraph 16 continues to state that: *“The cost of an item of property, plant and equipment comprises:*

- a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.”*

Extracts from IFRIC 21 Levies (IFRIC 21)

IFRIC 21 paragraph 1 provides background on the Interpretation as follows: *“A government may impose a levy on an entity. The IFRS Interpretations Committee received requests for guidance on the accounting for levies in the financial statements of the entity that is paying the levy. The question relates to when to recognise a liability to pay a levy that is accounted for in accordance with **IAS 37 Provisions, Contingent Liabilities and Contingent Assets.**”*

The scoping paragraphs 2 and 3 state that: *“2. This Interpretation addresses the accounting for a liability to pay a levy if that liability is within the scope of IAS 37. It also addresses the accounting for a liability to pay a levy whose timing and amount is certain.*

3. This Interpretation does not address the accounting for the costs that arise from recognising a liability to pay a levy. Entities should apply other Standards to decide whether the recognition of a liability to pay a levy gives rise to an asset or an expense.”

Paragraph 4 of the Interpretation defines a levy as: *“an outflow of resources embodying economic benefits that is imposed by governments on entities in accordance with legislation (ie laws and/or regulations), other than:*

- a) those outflows of resources that are within the scope of other Standards (such as income taxes that are within the scope of IAS 12 Income Taxes); and*
- b) fines or other penalties that are imposed for breaches of the legislation.*

‘Government’ refers to government, government agencies and similar bodies whether local, national or international.”

Paragraph 5 continues to state that: *“A payment made by an entity for the acquisition of an asset, or for the rendering of services under a contractual agreement with a government, does not meet the definition of a levy.”*

Analysis of the issue

Accounting treatment of non-refundable (absorbed) VAT portion of lease payments

A lessee shall measure the right-of-use asset at initial measurement in accordance with IFRS 16 paragraphs 23 and 24 such that the asset is recognised at cost. The cost of the right-of-use asset shall comprise, *inter alia*, of the following:

- the amount of the initial measurement of the lease liability per paragraph 26 of IFRS 16;
- any initial direct costs incurred by the lessee.

A lessee shall measure the lease liability at initial measurement in accordance with paragraph 26 of IFRS 16 at the present value of lease payments that are not paid at the commencement date.

Lease payments are defined in Appendix A as payments made by the lessee relating to the right to use the underlying asset in the lease contract during the lease term, comprising of fixed payments, variable lease payments that depend on an index or rate as well as the exercise price of a purchase option and penalties payable for terminating the lease. The definition provides for the exclusion of payments allocated to non-lease components, unless the lessee elects to combine and account for the non-lease component together with the lease component as a single lease component.

Issue: Whilst IFRS 16 provides guidance on the measurement of the right-of-use asset and the related lease liability, it does not provide explicit guidance on whether or not, the non-refundable (absorbed) VAT portion of lease payments should be included or excluded in the initial measurement of the lease liability and right-of-use asset.

Currently, there are diverse views with regards to what lease payments comprise of in terms of IFRS 16, as well as the application of the definition of what constitutes a levy in terms of IFRIC 21.

Based on the above, there are potentially 2 views on how to account for the non-refundable VAT relating to lease payments. These 2 views are summarised and set out below:

View 1 – Include the non-refundable VAT as part of the lease payment

The non-refundable VAT portion is not within the scope of IFRIC 21 as it does not meet the definition of a levy, given that the VAT is imposed by government on the lessor (not the lessee). The payment made to the lessor by the lessee, is within the scope of IFRS 16 and relates to the right to use the underlying asset in the lease contract. In addition, by applying the same accounting principles of IAS 16 to that of IFRS 16, the non-refundable (absorbed) VAT portion should be included in the lease payment as it is included in the capitalisation of the cost of a tangible asset in terms of IAS 16. This would therefore result in the VAT being included in the lease payments and consequently included in the measurement of both the right-of-use asset and lease liability at initial recognition.

Application of IFRS: View 1

Standard/Interpretation	Application
IFRS 16.24: “The cost of the right-of-use asset shall comprise:	VAT is a goods and services tax that is assessed incrementally, based on the increase in the value of a product or service at each stage

Standard/Interpretation	Application
<p>(a) the amount of the initial measurement of the lease liability, as described in paragraph 26...”</p> <p>IFRS 16.26: “At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date.”</p> <p>IFRS 16.27: “At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:</p> <p>(a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentive receivable...”</p> <p>IFRS 16.BC53: “Consequently, the IASB decided to require a single lessee accounting model for all leases recognised in a lessee’s balance sheet. This model requires a lessee to depreciate the right-of-use asset similarly to other non-financial assets and to account for the lease liability similarly to other financial liabilities.”</p>	<p>of production or distribution. VAT essentially compensates the relevant local authority for the shared services and infrastructure provided and is funded by its taxpayers that were utilised in the elaboration of that product or service.</p> <p>In applying the above definition to the IFRS 16 paragraphs as listed, if the VAT is non-refundable to the lessee, the payment thereof to the lessor should form part of the lease payments, as it relates to the right to use the underlying asset in the lease contract. Under this approach, the VAT would be included in the measurement of the lease liability and cost of the right-of-use asset.</p> <p>From the Basis for Conclusions of IFRS 16, the overall principle of the standard is to achieve the same presentation for assets leased as for tangible assets purchased. The basis of the above application therefore aligns to how entities capitalise the costs of Property, Plant and Equipment (PPE) (see section below). Under this approach, the VAT would be included in the measurement of the asset.</p>
<p>IFRS 16.15: “As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component.”</p>	<p>Entities may elect to apply the practical expedient and not separate non-lease components from lease components, but account for both as a single lease component. Under this approach, even if the non-refundable VAT portion is viewed as a non-lease component of the lease contract, this will not be separated out from the lease components.</p>
<p>IAS 16.16: “The cost of an item of property, plant and equipment comprises:</p> <p>a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.”</p>	<p>Where the VAT is non-refundable to the purchaser of an item of property, plant and equipment (asset), the payment thereof to the seller is viewed as being part of the costs of purchasing the asset when applying the requirements of IAS 16 as stated. Whether, an asset is purchased or leased, the payments can be made upfront or over time, both of which will include the non-recoverable VAT portion, following the principles of IAS 16. Following this, even when/if the VAT rate changes, there is still an obligation on the lessee to compensate the lessor which will include the updated VAT</p>

Standard/Interpretation	Application
	<p>charge. A change in the VAT rate meets the requirements to be accounted for as a change in estimate from the lessee's perspective in terms of IAS 8: <i>Accounting Policies, Changes in Accounting Estimates and Errors</i>. Under this approach, the VAT and any subsequent changes thereto would be included in the cost of the right-of-use asset and the measurement of the lease liability.</p>
<p>IFRIC 21.2: "This Interpretation addresses the accounting for a liability to pay a levy if that liability is within the scope of IAS 37. It also addresses the accounting for a liability to pay a levy whose timing and amount is certain."</p> <p>IFRIC 21.4: "... a levy is an outflow of resources embodying economic benefits that is imposed by governments on entities in accordance with legislation (ie laws and/or regulations), other than: (a) those outflows of resources that are within the scope of other Standards (such as income taxes that are within the scope of IAS 12 Income Taxes); and (b) fines or other penalties that are imposed for breaches of the legislation. 'Government' refers to government, government agencies and similar bodies whether local, national or international."</p> <p>IFRIC 21.5: "A payment made by an entity for the acquisition of an asset, or for the rendering of services under a contractual agreement with a government, does not meet the definition of a levy."</p>	<p>VAT is a goods and services tax that is assessed incrementally, based on the increase in the value of a product or service at each stage of production or distribution. VAT essentially compensates the relevant local authority for the shared services and infrastructure provided and is funded by its taxpayers that were utilised in the elaboration of that product or service.</p> <p>In applying the above definition to the IFRIC 21 paragraphs as listed, if the VAT is non-refundable to the lessee, the payment thereof to the lessor relates to the right to use the underlying asset in the lease contract in terms of IFRS 16, it is not a liability as defined in terms of IAS 37. Furthermore, the VAT is imposed by government on the lessor and not on the lessee. From the lessee's perspective, lease payments are made to the lessor in terms of IFRS 16, which includes a portion of VAT that can never be claimed back, and no payment is made by the lessee to government regarding this non-refundable VAT portion. If lease payments are not made to the lessor in terms of the lease contract, including the non-refundable VAT portion, the lessor has the right to remove the right of use of the underlying asset from the lessee.</p> <p>Under this approach:</p> <ul style="list-style-type: none"> a) in terms of paragraph 2, the non-refundable VAT is out of scope of IFRIC 21 as it does not relate to a liability in terms of IAS 37; b) in terms of paragraph 4, it would not meet the definition of a levy, as the VAT is imposed on the lessor entity and not the lessee. From a lessee's perspective, the outflow of resources relates to lease payments made in scope of another standard (i.e. IFRS 16) and c) lease payments made to the lessor relate to the right to use the underlying asset in the lease contract, which is similar to the

Standard/Interpretation	Application
	acquisition of a tangible asset from a seller and would therefore be scoped out of IFRIC 21 per paragraph 5.

View 2 – Exclude non-refundable VAT as part of the lease payment

The non-refundable VAT portion does meet the definition of a levy per IFRIC 21, as the payment thereof relates to an outflow of economic resources in accordance with legislation imposed on entities by local government. Even though the payment of the VAT is imposed on the lessor who is ultimately responsible for making the payment to government, by applying a look-through approach and by analogy, if the payment was not imposed on the lessor, the lessee wouldn't have the obligation to include such in payments made to the lessor. The obligating event to the lessee is the issue of each periodic invoice by the lessor, therefore the lessee should recognise a liability for each VAT payment on each invoice date, not at lease commencement. This would result in the non-refundable (absorbed) VAT portion not being included in the lease payments and consequently excluded from the measurement of both the right-of-use asset and lease liability at initial recognition.

Application of IFRS: View 2

Standard/Interpretation	Application
<p>IFRS 16.24: “The cost of the right-of-use asset shall comprise: (b) the amount of the initial measurement of the lease liability, as described in paragraph 26...”</p> <p>IFRS 16.26: “At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date.”</p> <p>IFRS 16.27: “At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date: (b) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentive receivable...”</p>	<p>VAT is a goods and services tax that is assessed incrementally, based on the increase in the value of a product or service at each stage of production or distribution. VAT essentially compensates the relevant local authority for the shared services and infrastructure provided and is funded by its taxpayers that were utilised in the elaboration of that product or service.</p> <p>In applying the above definition to the IFRS 16 paragraphs as listed, if the VAT is non-refundable to the lessee, the payment thereof to the lessor should not form part of the lease payments, as it does not relate to the right to use the underlying asset in the lease contract, but rather a levy in terms of IFRIC 21 (see below) for which the obligating event is the issue of each periodic invoice by the lessor. Under this approach, the VAT would be excluded from the initial measurement of the lease liability and cost of the right-of-use asset.</p>
<p>IFRS 16.15: “As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component.”</p>	<p>Entities may elect to apply the practical expedient and not separate non-lease components from lease components, but account for both as a single lease component. However, due to non-refundable VAT meeting the definition of a levy in terms of IFRIC 21 (see below), it is not regarded as a non-lease component of the lease contract. Under this</p>

Standard/Interpretation	Application
	<p>approach, the obligating event related to the payment of the VAT is the issue of each periodic invoice by the lessor. A lessee will therefore recognise a liability for each non-refundable VAT payment on each invoice date, not at lease commencement. The non-refundable VAT portion will therefore be excluded from the measurement of the lease liability and cost of the right-of-use asset at initial recognition.</p>
<p>IFRIC 21.4: “... a levy is an outflow of resources embodying economic benefits that is imposed by governments on entities in accordance with legislation (ie laws and/or regulations), other than: (c) those outflows of resources that are within the scope of other Standards (such as income taxes that are within the scope of IAS 12 Income Taxes); and (d) fines or other penalties that are imposed for breaches of the legislation. ‘Government’ refers to government, government agencies and similar bodies whether local, national or international.”</p> <p>IFRIC 21.5: “A payment made by an entity for the acquisition of an asset, or for the rendering of services under a contractual agreement with a government, does not meet the definition of a levy.”</p>	<p>VAT is a goods and services tax that is assessed incrementally, based on the increase in the value of a product or service at each stage of production or distribution. VAT essentially compensates the relevant local authority for the shared services and infrastructure provided and is funded by its taxpayers that were utilised in the elaboration of that product or service.</p> <p>In applying the above definition to the IFRIC 21 paragraphs as listed, even if the VAT is non-refundable to the lessee, it meets the definition of a levy as it represents an outflow of resources embodying economic benefits that is imposed by local government on entities in accordance with legislation. In terms of legislation, the payment of VAT is imposed by local government on lessors and is not in scope of any other IFRS Standard. Lease payments charged to lessees in terms of a lease contract are explicit in whether these charges include or exclude any VAT payments. If lease payments exclude VAT, a separate clause in the contract would be included to state that the lessee has an obligation to pay related VAT charges to the lessor. Therefore, from a lessee’s perspective, a look-through approach should be followed to determine which portion of lease payments made relate to the right to use the underlying asset per the lease contract and which portion relate to the payment of VAT. The payment of VAT does not relate to the right to use the underlying asset, but relates to a payment to be made by entities to government per local legislation, regardless of which entity has the ultimate responsibility to make the payment to government.</p> <p>Under this approach, the VAT should be recognised and measured in line with the</p>

Standard/Interpretation	Application
	principles of IFRIC 21. A lessee will therefore recognise a liability and corresponding expense for each VAT payment on each invoice date and not at lease commencement. The VAT does not represent a payment made for the acquisition of an asset and is therefore not scoped out of IFRIC 21 per the requirements of paragraph 5.

Conclusion: We do not believe that IFRS 16 provides sufficient guidance relating to the accounting treatment of the non-refundable (absorbed) VAT relating to lease payments and whether this should be included or excluded from lease payments as defined. Based on the above, there is currently divergences regarding which view is the appropriate accounting treatment for the recognition of the non-refundable VAT relating to lease payments and whether this should be included in the measurement of the right-of-use asset and lease liability or accounted for as a levy and therefore expensed, in terms of IFRIC 21.

Reasons for the Committee to address the issue

This issue is resulting in divergent views which could materiality impact the annual financial statements' presentation and disclosure. As, the inclusion of the non-refundable (i.e. absorbed) VAT in the measurement of the lease liability and right-of-use asset will result in a higher lease liability and right-of-use asset as well as a higher depreciation and interest expense charge whereas the exclusion thereof will result in the opposite.

Therefore, we believe that it would be useful for specific guidance on this matter to be issued, explaining how an entity should account for the non-refundable VAT portion of lease payments based on IFRS principles.

Importantly, this issue affects all preparers of financial statements that are lessees in a lease contract as defined by IFRS 16 and that pay a similar tax to VAT. This is because all such entities would need to consider how to treat any non-refundable VAT portion which that entity may be required to incur as part of the lease payment, either expensed as a levy in terms of IFRIC 21 or included in the measurement of the right-of-use asset and related lease liability in terms of IFRS 16.

We therefore believe that the Interpretations Committee can provide guidance surrounding the appropriate accounting treatment of the non-refundable VAT portion of lease payments, explaining whether such payments meet the definition of a levy in terms of IFRIC 21 or whether such payments meet the definition of lease payments in terms of IFRS 16.

In addition, we believe that, by the Interpretations Committee addressing this issue, financial reporting would be improved as preparers and users of financial statements would understand how the non-refundable VAT portion of lease payments is treated and will hence result in the improvement in the comparability and understandability of financial statements.