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Something old and something new

An overview of Tax Administration Jamaica's recent Technical Advisories on leases

May 2023

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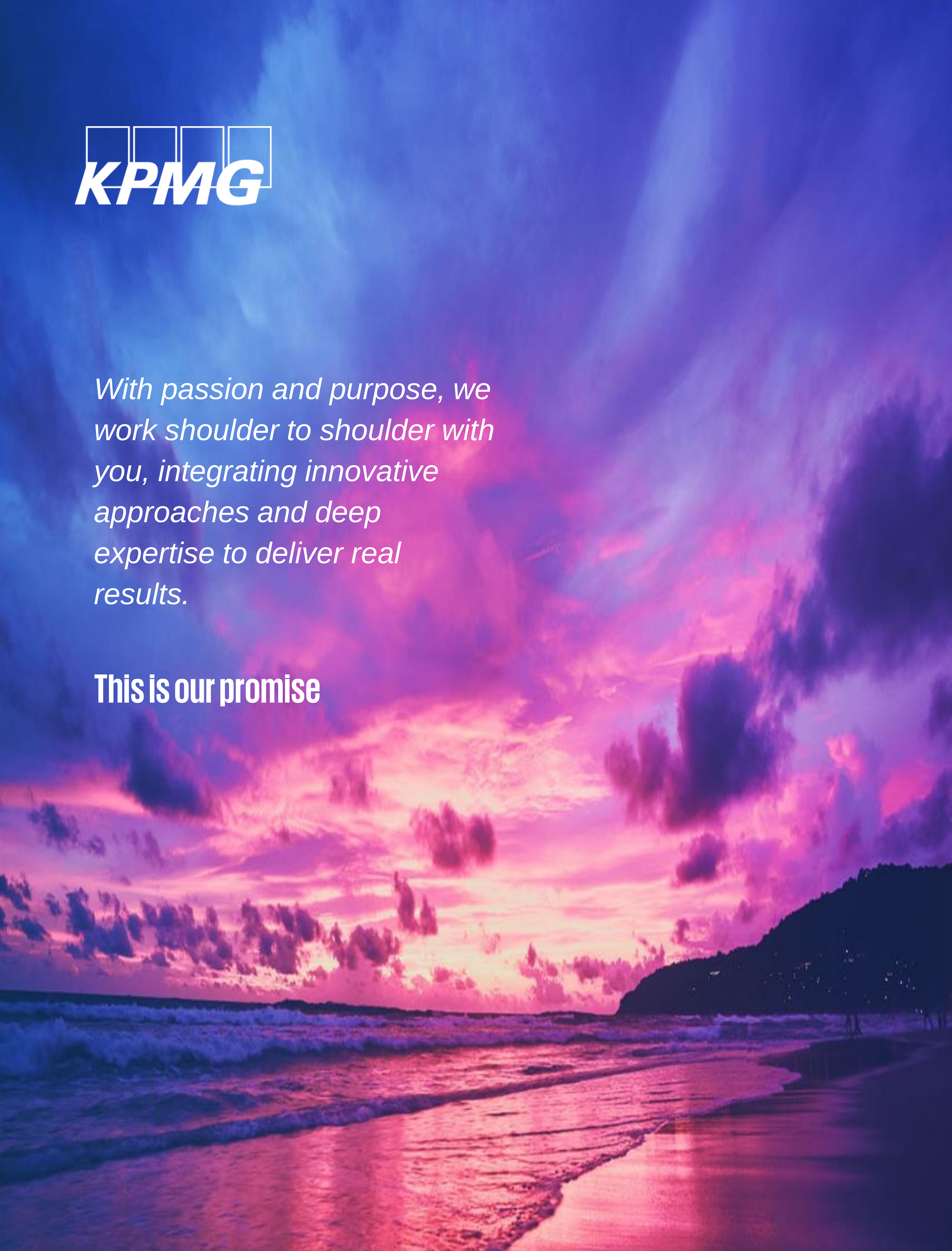

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Something old

Prior to January 1, 2023, and by virtue of Income Tax Circular 5/94 issued by the tax authorities in May 1994, operating and finance leases for assets, such as motor vehicles and industrial equipment, were treated the same for Income Tax purposes. The guidance at that time was that the entire lease fee for both types of leases was to be treated as a rental fee for hiring the asset. In practice, the two types of leases were also given a similar General Consumption Tax (“GCT”) treatment, in keeping with the Income Tax treatment, although there was no issued GCT guidance on this matter from the tax authorities. Over the years, with various changes in the International Financial Reporting Standards on leases, there has been uncertainty on the proper tax treatment of leases.

Existing lease arrangements

For tax purposes, lease arrangements that came into effect before January 1, 2023 will continue to be treated in accordance with the principles applicable at the time of their inception.

An existing lease arrangement for the same asset which is renewed / extended on or after January 1, 2023 will be treated as a new lease arrangement during the extended period. Such arrangements will be subject to the new tax treatments as outlined in the TAJ Technical Advisories.

What's new?

To clarify the matter, Tax Administration Jamaica ("TAJ") recently issued, two Technical Advisories on the Income Tax and GCT treatment of leases. The Technical Advisories "Income Tax Treatment of Leases" dated December 14, 2022 ("IT Advisory") and "General Consumption Tax Treatment of Leases" dated August 25, 2022 ("GCT Advisory") are summarized in this Bulletin. The guiding principles took effect on January 1, 2023.

Operating leases and finance leases now have different tax treatments and the parties to a lease arrangement must determine, and agree on, whether they have an operating lease or a finance lease.

What's new?

Income Tax

- For Income Tax purposes, the fee charged under a finance lease must be appropriately split between the portion that represents a repayment of the loan principal and the portion that represents the interest charged on the loan provided to the lessee to acquire the asset.
- Finance lessors' chargeable income will include only the interest income received from the lessee. Finance lessees' will only be allowed an income tax deduction for the interest expense paid to the lessor.
- Under a finance lease, since ownership and the burden of wear and tear passes from the lessor to the lessee, it is the lessee that will be entitled to claim capital allowances on the asset.

GCT

- For GCT purposes, where an asset is acquired under a finance lease and the leased asset is acquired in the lessee's name, there will be two transactions, the purchase of the asset and the deemed grant of a loan by the lessor.
- The finance lessee will be entitled to an input tax credit for GCT paid to the vendor for the purchase of the asset. The input tax credit claimed cannot exceed the GCT calculated on the cash price at which the vendor would have sold the asset to an unconnected party.
- The lease fee should be appropriately split between the loan principal repayable, and the interest charged. The total lease fee charged will not be subject to GCT, and the interest charged must be reported as a GCT exempt supply by the lessor.
- Where an asset is acquired under a finance lease and the leased asset is acquired in the lessor's name, there is a deemed sale of the asset by the lessor to the lessee at the time when the asset is made available to the lessee at the start of the lease period.
- The finance lessor must charge and account for GCT in the taxable period when the asset is made available to the lessee. The taxable value for the lessor's output tax is the amount on which the interest rate was applied to derive the aggregate minimum lease payments required from the lessee over the lease term, or the cash price payable.
- The periodic finance lease fee charged by the lessor throughout the lease term must be treated as a GCT exempt supply.
- The finance lessor will be entitled to an input tax credit for GCT paid to the vendor for the purchase of the asset. The input tax credit claimed cannot exceed the GCT calculated on the cash price at which the vendor would have sold the asset to an unconnected party.

The TAJ Technical Advisories indicate that for both tax types:

1. It is the lessor's responsibility to classify the lease contract, as either an operating or a finance lease. This should be arrived at by mutual contractual agreement with the lessee; and

2. Notwithstanding the above, the Commissioner General will determine whether a lease arrangement is impacted by Income Tax or GCT in the following circumstances:

   a. the contracting parties are unable to reach a mutually agreed position;
   b. the mutual contractual agreement is inconsistent with International Accounting Standard 17 ("IAS 17") and the practice acceptable to TAJ for Income Tax or GCT purposes; or
   c. the lessor and lessee are connected persons in accordance with section 2(2) of the Income Tax Act.

In essence, the Commissioner General will ensure that the transactions between connected persons are in keeping with transfer pricing rules. Transfer pricing rules dictate that a transaction between connected person should be at "arm's length". A transaction is defined as being "arm's length" where the price/cost of goods or services received, is similar to the price an independent third-party would pay.

Operating Lease or Finance Lease – What is the Difference?

Leases may be categorized as either operating leases or finance leases. Operating leases and finance leases are accounted for differently.

In summary, TAJ has defined an operating lease as an arrangement where the lease fee incurred by the lessee is primarily a rental charge for the temporary use of a non-current asset, and the risks and rewards incidental to the ownership of the asset remain with the lessor. On the other hand, a finance lease is defined as an arrangement where the risks and rewards incidental to ownership of the non-current asset are substantially transferred to the lessee.

TAJ has stated that where any of the 5 following criteria are met by a lease arrangement, then the lease may be treated as a finance lease for tax purposes:

• ***The lessor transfers ownership of the non-current asset to the lessee by the end of the lease term.***	• ***The lessee has an option to purchase the non-current asset at a price less than** its **fair value.***
• ***The lease term is at least 75% of the economic life of the non-current asset, even if title is not transferred.***	• ***At the start of the lease, the present value of the minimum lease payments amounts to at least 90% of the fair value of the leased asset.***
• ***The leased assets are of a specialised nature such that only the lessee can use them without major modifications being made.***	

In the event, that a financial arrangement is said to be a lease but does not fall within the above definition of an operating lease or a finance lease, the applicable tax treatment will be determined based on the details of the arrangement. In such cases, consideration will be given to the legal intent as well as the substance of the arrangement.

For tax purposes, effective January 1, 2023 all new lease contracts must be classified as either an operating lease or a finance lease.

Special considerations

Sale & leaseback transactions

Where a non-current asset is sold and leased back under a finance lease, the lessee (former owner) will be allowed to continue claiming the Capital Allowances as if the asset was never sold. TAJ will treat this transaction as if the lessee has secured a loan from the lessor against the asset. The interest paid by the lessee to the lessor will be treated as a deductible expense in respect of the finance lease

Where the asset is sold and leased back under an operating lease, the following will apply:

- If the asset is sold for more than its tax written down value, a balancing charge will be computed and taxed accordingly, and the lease fee treated as a deductible expense.
- If the asset is sold for less than its tax written down value and leased back at market value, a balancing allowance will be allowed immediately, and the lease fee treated as a deductible expense.

However, TAJ will need to evaluate the entire sale and leaseback arrangement if the asset is sold for less than its tax written down value and leased back at below market value.

Cancellation of a finance lease

If the lessee or lessor cancels the finance lease, the lessee can only claim a final capital allowance in the year of assessment in which the lease is terminated.

TAJ will not permit the lessee to compute and claim a balancing allowance in respect of the asset that was leased. This is so because the deemed capital expenditure incurred by the lessee would not be equivalent to the aggregate present values of all the minimum lease payments that the lessee was contractually bound to pay at the inception of the lease.

Where land and building are the subject of a finance lease, the same principles apply, except that where the aggregate present value of the minimum lease payments applicable to the land component can be computed, it must be excluded, since Capital Allowances cannot be claimed in respect of land.

International Accounting Standard 17 (IAS 17)

IAS 17 recognizes an asset acquired under a finance lease at the lower of its fair value and the present value of its aggregate minimum lease payments. However, the Income Tax Act only permits Capital Allowances to be claimed on the capital expenditure incurred by the lessor or the lessee, as the case may be.

Therefore, the present value of the aggregate minimum lease payments made by the lessee will be the basis on which the lessee can claim Capital Allowances. This is so because it is possible for the asset’s fair value to be less than the aggregate present values of the minimum lease payments made by the lessee. Indirect costs such as legal and administrative fees incurred by the lessee to acquire the asset, will qualify for Capital Allowances. However, depreciation expense is not tax deductible for lessors or lessees.

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