



# Accounting for VAT on leases

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During 2021 the IFRS Interpretations Committee (the IFRIC) considered the accounting treatment of non-recoverable VAT by lessees. The committee decided not to issue explanatory guidance or undertake standard setting activities in this regard. The accounting treatment of non-recoverable VAT does however seem to be contentious, even if its effect is not necessarily material and does not result in widespread diversity. This article highlights the areas that the comment letters submitted to the IFRIC and the commentary published by accounting firms suggest require some interpretation.

The accounting treatment of VAT was considered by the IFRS Interpretations Committee (the IFRIC) during some of its meetings in 2021. More specifically, the committee considered a request that related to the treatment of non-recoverable VAT paid by lessees.

Lessees may not be able to recover VAT paid on lease payments for various reasons. These include that:

- The lessee is not registered for VAT,
- The lessee does not use the leased asset for a purpose that qualifies for an input tax claim, such as using it to make VAT exempt supplies, or
- The VAT system does not allow the lessee to claim VAT on the specific type of asset that is leased.

The request asked whether the non-refundable VAT should be included in lease payments or not. The IFRIC concluded that based on the outreach conducted there was limited evidence that the non-refundable VAT was material or of diversity in practice that warranted standard-setting activity or further explanatory guidance on this matter.

If one considers the comment letters submitted to the IFRIC as well as commentary by accounting firms in their IFRS publications, it appears as if there are differing interpretations that preparers should be aware of. This article briefly considers the views in practice and the factors that may impact those interpretations. This may assist lessees for whom the effect of this VAT is material to describe their accounting policy, as paragraph 117 of IAS 1 requires.

### **Do not include in lease payments**

The definition of a lease payment in IFRS 16 refers to payments made *by a lessee to a lessor* relating to the right to use an underlying asset during the lease term. Most interpretations that support the view that the non-recoverable VAT should not be included in the lease payments, and therefore not affect the measurement of the right-of-use asset and lease liability, seem to be premised on the assumptions that the non-recoverable VAT essentially represents:

- a payment to the state or tax authorities, not the lessor, and
- is not a payment made in exchange for or in relation to the right to use the underlying asset.

This view is premised on the assumption that the lessor merely acts as a recovery agent for the payment by the lessee to the state, although the lessor may be legally obliged to pay the tax authority. The appropriate accounting treatment of the non-recoverable VAT would be to treat it as a government imposed levy in terms of IFRIC 21 *Levies* when invoiced. There may be grounds to capitalise the amount recognised in terms of IFRIC 21 as an asset.

The majority of the larger accounting firms endorse this interpretation.

### **Include in lease payments**

Interpretations in favour of including the non-recoverable VAT appear to follow a more legalistic view of the VAT flows. If the lessor is the primary obligor for the VAT, the lessee's obligation is limited to the payment of the VAT that it must make to the lessor. This brings it closer to being a lease payment.

Proponents of this interpretation also argue that this treatment results in the inclusion of the non-recoverable VAT in the carrying amount of the right-of-use asset. This aligns the treatment of non-recoverable VAT to that when a purchaser cannot recover VAT on an asset purchased outright.

### **In conclusion**

Despite not justifying an explanation in the IFRIC's agenda decision, the VAT treatment of non-recoverable VAT on lease payments by the lessee could be open for some interpretation. The brief analysis in this article suggests that the appropriate interpretation may depend on various factors, including the mechanics and characteristics of the VAT system, the legal obligations of the parties in respect of VAT as well as the timing of the VAT payment.

