BOOKKEEPERS
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BASE

Edition 17

Accounting for Leases

OVERVIEW

While arguably less complex to account for than hire purchases, leases can still be a minefield for bookkeepers. Firstly, there are two distinct ways to account for leases – one in which the leased asset itself is kept out of the balance sheet and the other where the leased asset is included in the balance sheet. Secondly, there are income tax considerations which need to be borne in mind. Finally, leases carry with them a number of issues from a GST standpoint.

These three areas will be explored throughout this newsletter. We will also devote a separate section to the topic of novated leases due to their increasing prevalence in the business community.

WHAT IS A LEASE?

Under a lease agreement, a person (the lessee) has the use of property for a specified period, in return for a series of payments that can be fixed or flexible. The person who grants the lease (lessor) remains the owner of the property.

Leasing agreements commonly apply to property such as buildings, vehicles, office equipment and machinery.

ACCOUNTING FOR LEASES

From a bookkeeping standpoint, the key question to ask when seeking to first record a lease is whether to:

a) record lease payments as expenses and ignore both the value of the leased asset and the associated lease liability; or
b) record the leased asset and associated lease liability in the balance sheet and charge depreciation and interest to the profit and loss statement.

The first treatment is said to be the preferable method for so-called operating leases while the second method for so-called finance leases.

The classification of a lease depends upon its economic substance. Where substantially all of the risks and benefits incident to ownership of the leased asset effectively remain with the lessor, the lease is an operating lease. Where substantially all of these risks and benefits effectively pass to the lessee, the lease is a finance lease. The risks of asset ownership include those associated with unsatisfactory performance, obsolescence, idle capacity, losses in realisable value, uninsured damage and condemnation of the asset; the benefits include those obtainable from the use of the asset and gains in realisable value.

In practice, bookkeepers employ method (a) above in the majority of cases, as it is decidedly simpler. However, it would be prudent to consult with your client's accountant to determine the manner in which they would prefer the leases recorded. It is conceivable that there may be compelling reasons why they would like to see method (b) applied. One such reason might be that a client's leased equipment is worth appreciably more than its corresponding liability. Method (b) will serve to add strength to the balance sheet in this scenario.

The practicalities of method (b) are outlined below.

Initial Entry

Where a lease is treated as a finance lease, you must recognise at the beginning of the lease term an asset and liability equal in amount to the present value of the minimum lease payments – in other words the amount financed.

Account	**Debit**	**Credit**
Leased Asset	xxx	
Lease Liability		xx

In practice, the above journal is complicated by the fact that input tax credits claimed over the life of the lease will serve to reduce the cost of the leased asset. The Case Study to this article outlines a methodology to account for this.

Depreciation of Leased Asset

An asset recognised under a finance lease is typically depreciated over the useful life of the asset. Where there is reasonable assurance at the inception of the lease that the lessee will obtain ownership of the asset at the end of the lease term, the useful life of the asset is the estimated life of the asset, not the term of the lease.

Account	Debit	Credit
Depreciation on Leased Assets	xxx	
Accumulated Depreciation		xx

It is advisable to record any such depreciation in a separate depreciation account to that of non-leased assets as the depreciation charge on leased assets will be non-deductible for income tax purposes. Segregating it will assist the accountant or tax agent in quantifying the non-deductible amount.

Reduction of Lease Liability

Lease payments must be allocated between interest expense and reduction of the lease liability. The interest expense must be determined according to a lease amortization schedule which splits the interest and principal component of each payment.

Account	Debit	Credit
Interest on Leased Assets	xxx	
Lease Liability	xxx	
Bank		xxx

Once again, it is advisable to record any such interest in a separate account to that of non-leased assets as the interest expense for leased assets will be non-deductible for income tax purposes. Segregating it will assist the accountant or tax agent in quantifying the non-deductible amount.

The case study at the conclusion of this newsletter will demonstrate further the principles that underlie the recording of finance leases.

INCOME TAX IMPLICATIONS OF LEASING

There are a significant number of variations to how a lease can be structured. Larger entities and corporate groups may indulge in complex leasing arrangements such as leveraged leases, equity leases, and sale and leaseback transactions. It is not, however, the intention of this article to explore the taxation implications of such instruments as they are governed by their own specific rulings and determinations.

Instead, our prime focus will be on the mainstream lease instruments that our bookkeepers face on a daily basis. We speak of the vehicle or equipment leases which involve a certain number of repayments with a residual payment at the end of the lease.

While ultimately the accountant is responsible for assessing the deductibility or otherwise of lease-related expenditure, a solid understanding of the income tax principles will assist you greatly as a bookkeeper in accounting for the transactions in the best manner.

Lease Payments

Lease payments, generally speaking, are deductible when they are paid. A possible exception to this rule would be the prepaying of lease payments crossing into the following financial year where the taxpayer in question is a Small Business taxpayer.

Stamp Duty

All Australian jurisdictions except Victoria and Tasmania impose duty on agreements of lease. In the majority of cases, the stamp duty component is simply added onto the monthly lease payment. Like the base lease payment, any stamp duty is also deductible.

Borrowing Costs

Leases are, in essence, another form of finance and like most forms of finance, will tend to carry with them borrowing costs at their outset. These could include stamp duty on the instrument of lease, valuation fees, documentation fees, search fees, etcetera.

The deduction in respect to borrowing costs is spread over the lesser of the period of the lease as specified in the lease agreement and 5 years. The deduction is calculated from the date that the lease takes effect.

Where, however, the total expenditure on all deductible borrowing costs does not exceed $100, the full amount is deductible in the year in which it is incurred.

Example
Helen takes out a 3-year lease on 1 April 2009 and in doing so incurs documentation fees of $180. This becomes a borrowing cost which is written-off over the lesser of the term of the lease or 5 years. In this case, the write-off period will be 3 years.

The annual write-off will be $60 (being $180 divided by 3) although in the first year, it will be pro-rated by 91/365 as the lease was taken out on 1 April 2009.

Lease Residual
A lease residual typically falls due for payment at the completion of a lease. At its heart, a lease residual is merely the price at which the lessor agrees to sell the leased asset to the lessee. Upon payment of the residual, ownership of the asset is conferred upon the lessee.

There are a number of courses of action which may transpire when the lease payment falls due:

1. *The lessee may pay the lease residual.* The payment of a residual is not a deductible lease expense, but rather a capital purchase. The asset would then typically fall under the depreciation provisions;

2. *The lessee may walk away.* The lessor retains property of the asset and there are no further tax implications for the lessee.

3. *The lessee may re-lease or refinance the lease residual.* A second lease agreement may be formed where a new series of lease payments are made towards the lease residual. A new residual is also quantified representing a percentage of the original residual. In such cases, it is simply the new series of lease payments which become deductible.

4. *The lessor may sell the leased asset to a third party.* Although the payment of the residual has not taken place by the taxpayer, they have nonetheless acquired the leased asset (a capital purchase) and at the same time (or contemporaneously) sold the asset to a third party via the lessor. If the two amounts are the same, no cash will change hands and there will be no income tax obligations to the lessee. If the sale proceeds exceed the lease residual, the lessor will remit the difference to the lessee and a profit on sale will ensue. If the sale proceeds are less than the lease residual, a loss on sale will result and the lessor will require that the lessee make good the shortfall.

Luxury Car Leases
Luxury car leases entered into on or after 20 August 1996, other than genuine short-term hire arrangements, are treated differently. A luxury car is one in which the cost of the car exceeds the so-called "car cost limit" which presently stands at $57,180.

In these circumstances, the Tax Office views the financing arrangement not as a lease, but rather as a notional sale and loan transaction. In effect, the lessee becomes the owner (in the Tax Office's eyes) until the lease term ends or the lease is terminated.

When a luxury car lease is entered into, the lessor is taken to have provided to the lessor a loan equal to the cost of the car and the total finance charge (e.g. interest) over the life of the lease. Lease payments are then regarded as repaying the notional loan and paying the finance charge.

Whereas typically lease payment themselves are deductible, in a luxury car lease, the lease payment will be non-deductible. Instead, the lessee will be entitled to deduct a finance charge and decline in value (depreciation) based on the car cost limit of $57,180.

Example
Regina, a non-GST registered taxpayer takes out a lease on a Porsche on 1 July 2009, costing $100,000 including GST. Regina uses the car 80% for business purposes per her logbook. The lease provides for 60 payments of $1,300 followed by a 40% residual amounting to $40,000.

As the vehicle is a luxury car, Regina cannot deduct the lease payments, and must instead deduct interest and depreciation (limited to the car cost limit). These deductions would be further diluted by her private usage of the vehicle.

Regina's calculation would be as follows:

Total repayments over life of the lease
= ($1,300 x 60) + $40,000
= $118,000

Interest component
= Total repayments over life of lease – Amount financed
= $118,000 - $100,000
= $18,000

Regina would need to determine the extent to which this interest is amortised over the life of the lease. It is higher in the earlier years, as the outstanding principal component is higher. Regina may need to employ specialist software to calculate the interest amortisation or she may be able to request such a schedule from the lessor.

We will assume for this example that the pattern of interest amortisation is as follows:

2009/2010	$5,500
2010/2011	$4,500
2011/2012	$3,500
2012/2013	$2,500
2013/2014	$2,000
Total	$18,000

The amount of interest that is deductible in the 2009/2010 year is:
= interest amortisation x business %
= $5,500 x 80%
= $4,400

The amount of depreciation that is deductible in the 2009/2010 year is:
= car cost limit x depreciation rate x (days/365) x business %
= $57,180 x 18.75% x (365/365) x 80%
= $8,577.

Sale of ex-leased assets

Once a leased asset is acquired by the lessee (e.g. upon payment of the residual), it is depreciated in the normal manner and, should it be sold, a profit or loss on sale will arise as normal (unless the asset has been pooled).

The exception to this rule is where the leased asset is a car and the taxpayer is not an STS taxpayer.

In these cases, the amount that is assessable to the lessee is the smallest amount of three separate calculations:

1. the difference between the cost and the residual paid to the lessor;
2. the amount of deductible lease charges over the life of the lease;
3. the actual profit made (e.g. sale price (excluding GST) less residual paid to lessor)

Example
Reggie leased a car for 3 years at an annual lease payment of $6,000. The cost of the car to the lessor was $48,000. After 3 years, she paid a residual of $20,000 and sold the vehicle six months later for $28,000 (GST-exclusive).

Her assessable profit is the lesser of:

- the difference between the cost and the residual paid to the lessor

= $48,000 - $20,000
= $28,000
- the amount of deductible lease charges over the life of the lease

= 3 x $6,000
= $18,000
- the actual profit made (e.g. sale price (excluding GST) less residual paid to lessor)

= $28,000 - $20,000
= $8,000

Thus, her assessable profit is $8,000

GST & BAS IMPLICATIONS OF LEASING
In outlining the GST & BAS implications of leasing, we will observe the same headings used in our preceding section on income tax.

Lease Payments
The provision of goods or services under a lease arrangement amount to a taxable supply for GST purposes and thus attract GST in the majority of cases.

The exceptions to this rule would be if the good or service being leased was:
- not connected with Australia;
- input taxed or GST-free in nature;
- being provided by a non-GST registered lessor;
- subject to transitional rules applying to certain leases signed before GST commenced (see later section entitled "Transitional Measures".

(For the purposes of the discussion that follows, we will assume these exceptions do not apply).

Although a lease is for a single supply of a good or service, it is a supply made for a period or on a progressive basis. Division 156 of the GST legislation governs such arrangement and provides that, from the lessee's point of view, the input tax credit for each progressive or periodic payment is attributed to the tax period in which the payment is made or earlier invoiced.

For BAS purposes, the taxable component of a lease payment (normally the amount of the lease instalment less stamp duty) would be included at label G11.

Stamp Duty
The stamp duty component of a lease payment will not attract GST. It does not constitute a supply for GST purposes and is thus non-reportable on the BAS.

The reason that is not reportable on the BAS, as opposed to being treated as a GST-free acquisition, is that it is a form of Australian tax, fee or charge that has been excluded from the GST by Determination 2000 of the Treasurer.

Borrowing Costs
Certain borrowing costs (e.g. documentation fees) will tend to include GST while others such as search fees may not.

It will be necessary to assess each style of borrowing costs on its merits to determine the GST impact. If there is GST, it will be attributable to the period in which the borrowing costs are paid (if you are on the cash basis for GST) or the period in which the borrowing costs are invoiced (if you are on the accruals basis for GST).

For BAS purposes, any borrowing costs which include GST will add to label G11, while any that do not will add to labels G11 and G14 on the GST calculation worksheet.

Although the tax deduction in respect to borrowing costs is normally spread over several years, the annual write-off is irrelevant for BAS purposes as it is the borrowing costs themselves, when levied, which are reportable.

Lease Residual
There are a number of courses of action which may transpire when the lease payment falls due:

1. *The lessee may pay the lease residual.* The payment of a residual to acquire an item will be a capital purchase. For BAS purposes, it would be included at label G10.

2. *The lessee may walk away.* There are no GST or BAS implications stemming from this course of action.

3. *The lessee may re-lease or refinance the lease residual.* It will be the new series of lease payments which attract GST and BAS implications.

4. *The lessor may sell the leased asset to a third party.* There are two separate supplies for GST purposes at work in this transaction. The first is a capital acquisition on the part of the lessee (see point 1 above). The second is a contemporaneous sale of the item by the lessee to a third party arranged by the lessor. In practice, how is this dealt with?

GST Determination GSTD 2001/2 considers that the sale of an asset by a lessor on the termination of a lease is a separate supply from the sale of the lease itself. Among other things, this means that if the lease was GST-free because it was entered into before 8 July 1999, the sale on termination of the lease may nevertheless be taxable if it occurs after 30 June 2000. This means that:

- if the lease was a pre-8 July 1999 lease that was GST-free, the payment of the excess or shortfall will have no GST implications;
- if the lease was fully taxable, the payment of the excess or shortfall will result in GST adjustments to the lessor and lessee.

Luxury Car Leases
In spite of the special rules that apply to luxury car leases for income tax purposes, no such limitation exists for GST. In other words, an input tax credit can be claimed for the full amount of the GST in a luxury car lease payment even though the market value of the car may exceed the luxury car limit.

Sale of ex-leased assets
The sale of an ex-leased asset is the same as the sale of any other asset for GST purposes. In short, it is a taxable supply and must be included at label G1 on the BAS.

Transitional Measures
Where a lease contract is entered into before 8 July 1999, the lease payments remain GST-free until the earlier of the date that a review opportunity arises or 1 July 2005. A review opportunity refers to an opportunity that arises under the contract for the supplier to change the payment directly or indirectly because of the imposition of GST or to conduct a general review, renegotiation or alteration of the payment.

Where a lease contract is entered on or after 8 July 1999, GST applies to any lease payments made after 30 June 2000.

The above dates are based on the lessee being entitled to full input tax credits. If the lessee is not entitled to full input tax credits, the key date becomes 2 December 1998 not 8 July 1999.

NOVATED LEASES
A subtle, but nonetheless common variation is the so-called novated lease whereby a tripartite lease arrangement is entered into between an employer, an employee and the lessee. In this case, lease payments are made by the employer to the lessor during the employee’s period of employ (and often times salary sacrificed). Should the employee cease to be employed (or the lease residual falls due), the ongoing lease obligations are transferred or “novated” from the employer to the employee.

A full or split full arrangement involves a lease agreement between the finance company and the employee, and a deed of novation (tripartite agreement) between the finance company, the employee and the employer.

The purpose of a tripartite agreement is for the three parties to agree to the transfer, from the employee to the employer, of all or some of the employee's rights and obligations in the original lease agreement. This is achieved by the deed of novation that revokes the original lease to the extent of the deed of novation.

With a full novation the employer will have responsibility for making the lease payments and guaranteeing the residual value of the goods at the end of the lease. With a split full novation the employer will assume all obligations under the lease agreement with the exception of guaranteeing the residual value of the vehicle. The employee retains this obligation.

Because the deed of novation revokes the original lease agreement, the supply of the vehicle is made directly by the finance company to the employer notwithstanding that the employee may retain the obligation to guarantee the residual value.

From an income tax standpoint, the lease payments made by employer are deductible, although if there is a private usage of the vehicle by the employee, fringe benefits tax implications will also arise.

From a GST standpoint, there is a taxable supply by way of lease from the finance company to the employer. Therefore, the employer will be entitled to an input tax credit if it makes a creditable acquisition. The employee is not the recipient of the supply by way of lease. Although the employee has the use of the vehicle, this is part of the employee's remuneration. There are no GST consequences for the employee. The finance company should provide a tax invoice to the employer, if requested, and not to the employee.

CASE STUDY

Facts

Clint owns a hydraulics factory and, on 1 January 2009, took out a lease on piece of equipment. The equipment cost $55,000 including GST and the lease provided for 36 equal instalments of $1,500 plus a residual of 40% being $22,000. In addition, a documentation fee of $275 including GST was incurred at the outset of the lease and paid by cheque.

On 1 February 2012, rather than paying the lessor the residual of $22,000, the lessor arranges for sale of the equipment to a third party for $27,000, thereby absolving Clint of further obligations under the lease. The lessor remits the $5,000 difference to Clint. The book written-down value at that time is $19,236.

Clint’s business is fixed asset intensive and he would like for the equipment and any associated lease liability to be shown on the balance sheet as he believes that over time he will accrue equity in these fixed assets.

As Clint’s bookkeeper, you must create the journal entries to cater for the above transactions.

Solution

To record the initial lease liability:

1 January 2009:

Account	Debit	Credit
Leased Asset	48,091.00	
GST Pending	6,909.00	
Lease Liability		55,000.00

Note: any input tax credits to which Clint is entitled will be crystallised not at the outset of the lease, but rather within each lease payment that he makes. As such, the future input tax credit entitlement is booked to an asset account called "GST Pending" at the outset of the lease. Progressively over the life of the lease, there will be a reallocation from GST Pending to GST Paid. The future input tax credit entitlement is given by the total lease payments including residual multiplied by 1/11th.

= [(36 x $1,500) + $22,000] x 1/11
= $76,000 x 1/11
= $6,909

To record the payment of borrowing costs:

1 January 2009:

Account	Debit	Credit
Borrowing Costs Asset	250.00	
GST Paid	25.00	
Bank		275.00

Note: although GST on borrowing costs can be claimed at this point, for income tax purposes the borrowing costs must be expensed over the lesser of the term of the lease or five years, with any broken years calculated on a day's basis.

Calculate the borrowing costs write-off:

Year	Write-Off	Calculation
2008/2009	$41.32	$250/3 x 181/365
2009/2010	$83.33	$250/3
2010/2011	$83.33	$250/3
2011/2012	$42.01	$250/3 x 184/365

Prepare a lease amortisation schedule:

Clint obtains a schedule from his lessor setting out the principal and interest component of each repayment, an excerpt of which follows:

Payment	Amount	Principal	Interest	Balance
				$55,000
Jan '09	$1,500	$1,050	$450	$53,950
Feb'09	$1,500	$1,060	$440	$52,890
Mar'09	$1,500	$1,070	$430	$51,820
……				
……				
Dec'11	$1,500	$1,400	$100	$22,000
Jan '12	$22,000	$22,000	$0	$0

To record the monthly lease payment for January 2009:

Account	Debit	Credit
Interest on Leased Assets	450.00	
Lease Liability	1,050.00	
Bank		1,500
GST Paid	136.36	
GST Pending		136.36

Note: The re-allocation between GST Pending and GST paid is for 1/11th of the amount of lease payment. For accounting software users posting tax-coded transactions in GST-inclusive terms, a clever way to achieve the effect of the final two lines of this journal is to debit GST Pending with a GST code for $1,500, and credit GST Pending with an N-T code for $1,500. The software will produce the following entry:

Debit	GST Pending	$1363.64	
Debit	GST Paid	$136.36	
Credit	GST Pending		$1,500.00

All subsequent lease payments would be recorded the same except that the amount of interest expense and reduction in lease liability would be based on the lease amortisation schedule.

To record the borrowing cost write-off:

30 June 2009

Account	Debit	Credit
Borrowing Costs Expense	41.32	
Borrowing Costs Asset		41.32

Depreciation:

Depreciation on the leased equipment would be calculated using normal principles except that the entry to record the depreciation charge should highlight the fact that it is depreciation relating to a leased asset. Assume a depreciation rate of 20% prime cost is applied to the asset. The charge for the 2008/2009 year would be:

= (Cost of asset less future input tax credits) x rate x days/365
= ($55,000 - $6,909) x 20% x 181/365
= $4,769.57

Account	Debit	Credit
Depreciation on Leased Assets	4,769.57	
Accumulated Depreciation – Leased Asset		4,769.57

For income tax purposes:

Clint's accountant would need to increase profit by the non-deductible depreciation and interest charges, and then reduce profit by the GST-exclusive lease payments paid throughout the year.

We will now skip ahead to 1 February 2012 when the lease residual falls due.

Record the contemporaneous transaction occurring when the residual is due:

Account	Debit	Credit
Lease Liability	22,000.00	
Bank	5,000.00	
Profit on Sale of Leased Assets		24,545.45
GST Collected		2,454.55
GST Paid	2,000.00	
GST Pending		2,000.00

Write-back accumulated depreciation:

Account	Debit	Credit
Accumulated Depreciation – Leased Asset	28,855.00	
Profit on Sale of Leased Assets*	19,236.00	
Leased Asset		48,091.00

* Closing written down value of asset in the books of account.

services for their clients. It is not intended to be taken as a substitute for you or your clients seeking professional advice in relation to their own specific circumstances.