FEDERAL INLAND REVENUE SERVICE
Revenue House, Abuja

INFORMATION CIRCULAR

No. 2010/01
Date of Publication: 12th April, 2010

GUIDELINES ON THE TAX IMPLICATIONS OF LEASING

This Circular is issued pursuant to:

- *Section 8(1)(c) of the FIRS Establishment Act 2007*
- *Section 80 of the Companies Income Tax Act (Cap C.21, LFN 2004);*
- *Paragraph 18 of the Second Schedule of Companies Income Tax Act (Cap C.21, LFN 2004) as amended;*
- *Section 2 of Value Added Tax Act (Cap. VI, LFN 2004) as amended; and*
- *Section 3 of Capital Gains Tax Act (Cap. C1, LFN 2004) as amended.*

This circular which supersedes FIRS Information Circular 9503 of July 1st 1995 provides guidelines on the application of Companies Income Tax, Withholding Tax, Value Added Tax and Capital Gains Tax provisions to Leases. It is to draw attention of the general public, especially Leasing Companies, Banks, Insurance Companies, Finance Companies, Solicitors, Tax Consultants, and other interested individuals to the tax implications of leasing.

1.0 Introduction:

In recent times in Nigeria, leasing has become an attractive means of financing the acquisition and use of fixed assets; this attraction is heightened by the very high cost of fixed assets, the scarcity of foreign exchange to pay for imports, and the relative ease of access to credit facilities through leasing. It is hoped that this circular will clarify the misconceptions and misinterpretations of the principles guiding lease arrangements in Nigeria.

The Nigerian Accounting Standard Board (NASB) published the Statement of Accounting Standard 11 (SAS 11) on leases in 1991 as a result of the increase in lease arrangements. According to the standard, "***the financial statements published in Nigeria contain little or no information on lease transactions; some of which involve huge annual financial commitments***". It is in the light of the numerous leasing arrangements in operation in Nigeria that this circular has come to explain the tax implications of leases to both the Lessee and the Lessor.

2.0 **Definition of Lease:**

SAS 11 defines Lease as "***a contractual agreement between an owner (The Lessor) and another party (The Lessee) which conveys to the lessee the right to use the leased-asset for consideration usually periodic payments called rents***".

3.0 **Classes of Leases**

There are two broad classes of leases:

- Finance or Capital Lease
- Operating Lease

3.1 **Finance Lease:**

This is a lease in which risks and rewards of ownership are transferred to the lessee; who is under obligation to pay such costs as insurance, maintenance and similar charges on the asset in addition to periodic lease rentals. In most cases, a finance lease agreement is non-cancellable and the Lessee has an option to buy the asset for a nominal amount at the expiration of the lease term. The agreement usually provides for the payment of periodic rentals to cover capital repayment and interest computed at specific rates.

3.1.1 Features of Finance Lease

- It is non cancellable; and

  a) lease term covers substantially (80% or more) of the useful life of the asset; or net present value of the lease at inception, using the minimum lease payments and the implicit interest rates; <u>or</u>

b) the lease has a purchase option which is likely to be exercised.

- The ownership risks and rewards are transferred to the lessee;
- The lessee is under obligation to pay such cost as insurance, maintenance and similar charges on the asset;

Other variants of finance lease are:

- **Leverage Lease** is a three- party arrangement involving a lender (often a financial institution) in addition to the usual Lessor or Lessee. In most cases, the lender provides the greater part of the purchase price of the leased asset.
- **Sales-Type Lease** is one where the Offeror or dealer (Lessor) transfers substantially all the ownership risks and benefits of the property to the Lessee. At the inception of the lease, the fair value of the leased property is greater or less than its carrying amount in the books of the Lessor resulting in a profit or loss to the Lessor who is often a manufacturer or dealer.

3.2 Operating Lease:

An operating lease is any other lease other than a finance lease. Under such an arrangement, the Lessor, while granting the Lessee the right to use the leased property, retains ownership of the property, risks, obligations and benefits associated with ownership in addition to the lease rentals that he receives.

The features of an Operating Lease include:

- The risk and ownership of the asset remains with the Lessor
- The lease is for a shorter period of time than in a finance lease though the life span of the lease may not be known at the beginning;
- The lease may be cancelled or renewed as may become necessary;
- The Lessor is under obligation to pay such cost as insurance, maintenance and similar charges on the asset.

3.3 Sub-leases

At times, a lease agreement allows the lessee to sub-lease to a third party who becomes a sub-lessee. In such a case, the original Lessee becomes the Lessor and all or some of the rights or obligations under the original lease are transferred to the new lessee.

According to Statement of Accounting Standards on leases, SAS 11, the accounting treatment of a sub-lease is not different from that accorded to a normal or original lease because there is a lessor and a lessee, respectively. The original Lessee treats all the transactions pertaining to a sub-lease as a lessor while the sub-lessor treats them as a lessee accordingly. The initial Lessee continues to account for the original lease as a lessee.

3.4 **Sale and Leaseback** is one in which the seller of the property leases it back from the buyer. This kind of arrangement is like borrowing money and pledging the fixed asset in question. A company which engages in this type of arrangement stands to enjoy the following benefits:

(i) the company realizes money from the sale;

(ii) the company may also make balancing allowances there from;

(iii) The company enjoys capital allowances from the asset despite the disposal since it has been leased but this has to be finance lease to be so; and

(iv) The instalmental payments being made by the company is tax deductible.

In effect, this arrangement can be used as a means of financing a company as well as tax savings.

4.0 **Tax Implications of Lease Arrangement**

4.1 Finance (Capital) Lease

4.1.1 <u>Tax Issues for the Lessor</u>

i) **<u>Companies Income Tax (CIT)</u>**:

- The interest portion of the rent earned by the Lessor constitutes taxable income in the hand of the Lessor;
- Capital portion is a repayment of initial investment and has no tax implication;

- The Lessor is not entitled to claim capital allowances on the leased assets; only the Lessee is entitled to make such claims. (If the Lessor makes any such claim for capital allowances, FIRS will disallow it).

ii) **<u>Withholding Tax (WHT)</u>**:

Withholding tax is computed only on the interest portion of the total lease payment due from the lessee. The Lessor will receive lease rent less 10% WHT. The credit note will be issued in the name of the Lessor who can use it to offset its income tax liability for the relevant period.

iii) **<u>Value Added Tax (VAT)</u>**:

Interest earned by the Lessor on finance lease is a return on investment and is not liable to VAT.

iv) **<u>Capital Gains Tax (CGT)</u>**:

If the asset is disposed at the expiration of the lease period, any capital gain realised would be subject to CGT.

4.1.2 Tax Issues for the Lessee

i) **<u>Companies Income Tax (CIT)</u>**:

- The Interest portion of the periodic lease rent and other related expenses such as insurance, maintenance cost are deductible expenses for income tax purposes;
- The lessee is entitled to claim capital allowance on capital portion of the value of the leased-assets;

ii) **<u>Withholding Tax (WHT)</u>**:

The Lessee has a duty to withhold tax at 10% on the interest portion of the lease rental and to remit same to FIRS.

iii) **<u>Value Added Tax (VAT)</u>**:

The input tax incurred on purchase of the assets is to be capitalised with the cost of the asset.

iv) **<u>Capital Gains Tax (CGT)</u>**:

CGT will not be applicable to the Lessee unless the gain arose from the sale of his interest in the lease. However, he will be liable to CGT if the leased asset was sold by him after exercising the purchase option.

4.2.0 **Operating Lease**

4.2.1 **Tax issues for the Lessor**

i) **<u>Companies Income Tax (CIT)</u>**:

- The total Lease rental received or receivable by the Lessor is income and it is wholly taxable;
- The Lessor is entitled to claim capital allowance on the leased assets.

ii) **<u>Withholding Tax (WHT)</u>**:

Withholding tax computed on the total lease rental must be deducted from the sums due from the Lessee. The withholding tax due is at 10% of the total rental income due on the lease.

iii) **<u>Value Added Tax (VAT)</u>**:

The lease rental income is liable to VAT; the Lessor is to include a 5% VAT charge on its invoice to the lessee.

4.2.2 **Tax Implication for the Lessee**

i) **<u>Companies Income Tax (CIT)</u>**:

- The rental charges and other associated expenses are allowable deductions for tax purposes;
- Capital allowances can only be claimed by the Lessor; capital allowances should not be claimed by the lessee on assets under operating lease;

ii) **<u>Withholding Tax (WHT)</u>**:

The Lessee shall withhold tax at 10% from the rental payment to the Lessor and remit same to the relevant tax authority.

iii) **<u>Value Added Tax (VAT)</u>**:

VAT charged by the Lessor on the lease rental charge is not an input tax to the Lessee; it is to be charged to the Profit & Loss Account.

4.3 Capital Allowances under Lease Arrangements

4.3.1 Capital Allowance under Operating Lease Arrangements

Paragraph 18(1b) of the second schedule to the Companies Income Tax Act (CAP C.21, LFN 2007) provides that “where a company owning an asset leases that asset to any person under an operating lease contract for use wholly, exclusively, necessarily and reasonably, for the purpose of a trade or business carried on by such person, the provision of this schedule shall apply as though the expenditure were incurred for the purpose of a trade or business carried on by the owner or Lessor and as though the owner or Lessor were using the asset for the purpose of such last mentioned trade or business in the way in which and for the period or periods during which the asset is in fact in the first- mentioned trade or business”. In essence, capital allowances can only be made by the Lessor under an operating lease arrangement.

4.3.2 Capital Allowance under Finance Lease Arrangement

In the case of a finance lease, paragraph 18 (2) of the 2nd schedule to Companies Income Tax Act (CAP C.21, LFN 2007) provides that “where however an asset is acquired by any hirer or lessee under a finance lease contract the term of which provide for the transfer of ownership, risks and reward to the hirer or lessee, the provisions of this schedule shall in the same way as it applies to an asset acquired by any owner or Lessor of an asset for the purpose of his trade or business, but shall so apply subject to the following modifications that is to say:

a) The qualifying expenditure within the provisions of this schedule shall in relation to any asset so acquired under that contract, be limited to the amount of the total lease payments due from the hirer or lessee, during his basis period excluding in the computation of such qualifying capital expenditure any interest or charges payable under the contract;

b) Any reference in this subparagraph to any owner/Lessor of any asset shall be construed as including a reference to a hirer or lessee under finance lease contract and as excluding a reference to the person leasing the asset to the hirer or lessee under the contract.”

Following from the foregoing provision, the claim for capital allowances under a finance lease arrangement can only be made by the lessee. The Act further states that the qualifying expenditure shall be limited to the total lease payments due from the lessee to the Lessor; in effect interest charges payable by the lessee to the Lessor is not a qualifying capital expenditure and does not qualify for capital allowances.

5.0 Leasing as a separate line of business:

It is a common practice for some organizations to engage in leasing as a separate line of business apart from their primary business line; there is nothing illegal about such practices as long as it is within the memorandum of association of the company concerned. The tax implication for lease remains the same whether it is finance or operating lease arrangement.

Howbeit, it is imperative to state that any organisation which carries out the business of leasing either as a separate line of business or an additional line of business must ensure that such transactions are properly disclosed in the financial statements in compliance with SAS 11.

Furthermore, section 29 of CITA (CAP C.21, LFN 2007) provides that companies should disclose assessable profit from each source or line of business. A proper distinction must therefore be made between the lines of business in which the enterprise is engaged and the profit from each source. Tax payers are advised to be mindful of this requirement in order not to run foul of the provision of section 42 of the FIRS (Establishment) Act, 2007.

APPENDIX

1.0 Example of a finance lease

FFF Limited leased manufacturing equipment from GGG Leasing Limited. The total lease sum is N15 Million; but the fair market value is ₦10 Million. The equipment has an economic life of 5 years, The lease term is 4 years with an option to buy the equipment lease for ₦100,000 by the lessee. The lease is not cancellable and the lessee is responsible for maintenance, insurance and upkeep of the equipment.

In accordance with the provisions of SAS 11, the example given above is a finance lease. This is so because the lease is not cancellable, the lease term is 80% of the useful life of the assets, the lease agreement contains a purchase option and the Lessor would have recovered substantial part of his investment and possibly made a reasonable return thereof.

1.1 Example of an operating Lease:

MAN Haulage Company Limited leased a truck from Auto Motors Limited. The cost of the truck is ₦15 Million and monthly lease payment is ₦300,000 payable at the beginning of each month; the Lessor is responsible for repairs, maintenance and registration of the vehicle while the Lessee takes care of fuelling, lubrication, tyres replacements. The expected useful life of the truck is 10 years. The lease term is 2 years in the first instance and it is renewable subject to agreement by the two parties; either party can also opt out of the arrangement after 3 months notice.

According to the provisions of SAS 11, this is an example of an operating lease. The lease has a cancellable provision, the lessee can only be sure of using the asset for 2 years out of the expected life span of 10 years. The Lessor takes responsibility for day to day upkeep and maintenance of the truck and furthermore the lease does not provide for any purchase option.

1.2 Example XYZ Nigeria Limited

XYZ Nigeria Limited is a manufacturing company which has incurred an assessable loss of ₦20 Million at the end of the financial year 31st December 2006. In addition to the above, the company has leased out some under-utilized factory machineries. The net profit made from this leasing business is ₦5 million.

On 2nd June 2006, XYZ also sold one of its buildings which had been acquired in January, 2006 at a cost of ₦500 Million for ₦550 million to ABC Ltd. On the same day, XYZ leased back the building under the following terms.

i) On finance lease terms for 3 years non- cancellable

ii) The lease rental is ₦20 Million (inclusive of interest) payable 31st December each year.

iii) Interest payments of ₦5m, ₦3.5m and ₦2.75m are to be made by XYZ for the years 2006, 2007 and 2008 respectively.

iv) The lessee has the option to purchase the building for ₦650m at the expiration of the lease term.

Required:

i) Compute the tax payable and the loss carried forward by XYZ Nigeria Limited for the year ended 31st December, 2006.

ii) Compute the withholding tax to be deducted by the lessee from the total lease rental due to the Lessor for years 2006 – 2008

iii) Determine the VAT expected to be charged by the Lessor on the transaction he made with the lessee.

iv) Is the lessee entitled to claim input tax paid?

v) Determine the Capital Gains Tax due from the Lessor if the lessee exercises the option of purchasing the building on the expiration of the lease term.

vi) Is the lessee liable to Capital Gains Tax in this circumstance?

vii) Is the Lessor entitled to claim capital allowance? If yes what is the basis for this?

viii) Is the lessee entitled to claim capital allowances? If yes what is the basis for this?

Suggested Solution:

i) **<u>Computation of tax payable for the year ended 31st Dec, 2006</u>**

	₦'000
Loss from Manufacturing activity	(20,000)
Profit from Leasing activity	5,000
Tax payable (30% of ₦5 Million)	**1,500**
Loss Carried Forward	**20,000**

Based on the above, XYZ Nigeria Limited is required to disclose the profit from each line of business and separately subject the profit of ₦5m which arose from the leasing business to tax. The loss of ₦20m will be available to be carried forward for relief in subsequent years.

ii) **<u>Computation of WHT to be deducted by Lessee (XYZ)</u>**

	2008	**2007**	**2006**
	₦	**₦**	**₦**
Interest	**2,750,000**	**3,500,000**	**5,000,000**
Withholding Tax @10%	275,000	350,000	500,000

(Note that under a finance lease arrangement, withholding tax is computed on only the interest portion of the lease rental)

iii) **<u>Determination of VAT chargeable by Lessor (ABC Ltd)</u>**

This is a finance lease. The lease rental receivable by the Lessor is a return on investment; VAT is therefore not applicable.

iv) **Whether Lessee is entitled to claim input Tax**

The Lessee is not expected to claim input tax. He is expected to have capitalized the any VAT paid on acquisition of the asset with the actual cost of the assets.

iv) The Capital Gains Tax Liability of the Lessor:

10% of (₦650m – ₦550m) = ₦10m

FORM VAT 005

v) The Lessee's Capital Gains Tax Liability is:

10% **x** (₦550m – ₦500m) = ₦5m

vi) This is a finance lease arrangement. The Lessor is not entitled to claim Capital Allowances; it is the Lessee that has the right to claim capital allowances under a finance lease arrangement.

9.0 Enquiries

All enquiries on any aspect of this circular are to be directed to the under-listed addresses:

Executive Chairman, Federal Inland Revenue Service, Revenue House, Plot 522, Sokode Crescent, Wuse Zone 5, Abuja Email: firsinfo@firs.gov.ng;	OR	Director, Tax Policy, Federal Inland Revenue Service, Revenue House, Plot 522, Sokode Crescent, Wuse Zone 5, Abuja Website: www.firs.gov.ng