K. TREPPIDES & CO LTD

Direct Taxation

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Tax treatment of the impact on the financial statements from the application of IFRS 9, IFRS 15 and IFRS 16

We would like to inform you that on the 17th of May 2021, the Tax Department has issued an Implementing Guideline (15/2021) which provides useful clarifications in relation to the tax treatment of the impact on the financial statements from the application of IFRS 9, IFRS 15 and IFRS 16 for the purposes of the calculation of Income Tax as well as the Deemed Dividend Distribution (DDD) that is subject to Special Defence Contribution (SDC).

I. IFRS 9 – Financial Instruments

IFRS 9, which is effective for reporting years as of 1 January 2018, specifies how an entity should recognize and measure financial assets and liabilities. Write-offs and provisions on financial instrument are now recognised based on the 'expected loss model' and are thus recognized earlier than under IAS 39, where such write-offs/provisions were recognized based on past events.

As a background, according to Article 9(1)(c) of the Cyprus Income Tax Law, the following items should be deductible for income tax purposes, provided that certain conditions are met:

a. Bad Debts of any business that became irrecoverable and written off during the year of assessment.
b. Specific provisions for doubtful debts provided that the Tax Department is satisfied that those debts have or will eventually become irrecoverable.

Based on the above, the tax treatment of the write offs/provisions that are recognized under IFRS 9 will be as follows:

For companies other than credit institutions

IFRS 9 does not affect the tax treatment of the write-offs/provisions of trade receivables that was applied up to tax year 2017 and should therefore remain as follows:

a. Writing-off **bad debts** should be allowable in cases where the taxpayer can prove that although relevant measures for their collection were taken, the receivables have become irrecoverable, and as a result, the company has proceeded to write-off those amounts.
b. As above, **special provisions for bad debts** should be allowed in cases where the taxpayer can prove that although relevant measures for their collection were taken, and based on the specific facts of each case, it is practically difficult to recover those amounts.
c. **General provisions for bad debts** that are not based on the specifics of each case (e.g. based on past practice), should not be allowable.

It should be noted that under IFRS 9, companies may apply the 'simplified calculation method' for their expected credit losses as long as the amount is calculated on an individual basis. Any amount that is calculated on a collective basis will not be allowed.

From the tax year 2018 onwards, for the purposes of determining the taxable income of any person, the provisions and write-offs for any trade receivables that are recognized under IFRS 9 may be deductible provided that the taxpayer can prove that the requirements of paragraphs (a) or (b) above are met.

The amount of the initial provision recognized as at 1 January 2018 directly in the reserves as a result of the introduction of IFRS 9, may be deducted from the taxable income in the tax year during which the taxpayer can prove that the conditions stipulated in paragraphs (a) or (b) above are met.

For credit institutions

According to IFRS 9, all credit institutions are required to follow a 'general approach' for recognition of their expected credit losses on loans and other receivables. This approach results in provisions of three stages, and their tax treatment is as follows:

a. Any provisions made in a given year in relation to loans and receivables from customers classified under Stage 1 (low credit risk) and Stage 2 (significant increase in credit risk since initial recognition), should not be deducted from the taxable income.
b. Provisions made in a given year in relation to loans and receivables from customers classified under Stage 3 (credit impaired) or POCI (purchased or originated financial assets that are credit-impaired on initial recognition) should be treated as deductible from the taxable income.

The Guideline clarifies that in a given year, if a Stage 1 or Stage 2 provision is re-classified under Stage 3, then any accumulated provision that was previously disallowed, along with the additional current year provision under Stage 3, may be claimed as deductible from the taxable income in the said year. Similarly, if in a given year, a Stage 3 provision is re-classified under Stage 1 or Stage 2, then any accumulated provisions that were previously allowed, should now be added to the taxable income of the said year (i.e. recapturing of previously claimed tax deductions).

The initial provision that had been recognized by any credit institution on 1 January 2018 and had been recorded in the institution's reserves due to the introduction of IFRS 9, is deductible from the taxable income of 2018, to the extend it relates to loans and receivables from customers that are classified under Stage 3 or POCI.

In order for the credit institution to proceed with the write-off of their customers' loans and receivables, they must be able to prove that although necessary measures were taken for their recovery, they have become irrecoverable and were thus, written off.

The Tax Department may request to be provided with supporting evidence as well as information on the approach that the credit institution has applied for the recognition of their expected credit losses on loans and other receivables.

Tax treatment of write-offs/provisions of receivables for DDD purposes (applies to all companies including credit institutions)

Recognition of write offs/provisions of receivables under IFRS 9 is not considered as revaluation for DDD purposes.

Therefore, provisions and write-offs of receivables that are recognized in the accounting profit in accordance with IFRS 9 should be allowable for the purpose of the calculation of SDC on DDD, and no adjustment needs to be made to the accounting profit in this respect.

The initial amount of write-offs/provisions of receivables recognized as at 1 January 2018 and are recorded directly in the reserves following the introduction of IFRS 9, is deducted from the accounting profit of 2018 for DDD purposes; therefore the relevant adjustment should be made to the DDD calculation.

II. IFRS 15 – Revenue from Contracts with Customers

IFRS 15, which is effective for reporting years as of 1 January 2018, provides guidance on accounting for revenue from contracts with customers.

Given the complexity of the standard, the tax treatment for the income that is recognized under IFRS 15 should be consistent with the accounting treatment, both for income tax purposes and for SDC purposes with regards to DDD.

The initial adjustment to the reserves on 1 January 2018 following the introduction of IFRS 15, should form part of the profit for income tax purposes as well as for the calculation of SDC on DDD and the necessary adjustments should therefore be made to the respective calculations.

It should be noted that if there are existing Circulars, Guidelines or Regulations in place that regulate the tax treatment of revenue for specific sectors or specific types of income, then those should be applied irrespective of the accounting treatment as per the IFRS 15 (e.g. construction contracts for developers).

III. <u>IFRS 16 – Leases</u>

IFRS 16, which is effective for reporting years as of 1 January 2019, provides guidance on the accounting treatment of leases.

The IFRS 16 application does not affect the tax treatment of leases and the determination of the taxable income. Therefore, the treatment that has been applied up to 2018 shall continue to apply, as further explained below.

The adjustment to the lessee's reserves, following the introduction of IFRS 16 as of 1 January 2019, does not affect the taxable income for 2019.

Tax treatment for the lessee for operating leases: The annual lease expense incurred by the lessee should be tax deductible provided that the asset is used for business purposes.

Tax treatment for the lessee for finance leases: The capital allowances on the cost of the leased asset and any interest expense incurred on the lease liability, should be tax deductible.

<u>*Tax treatment of leases for DDD purposes*</u>

The lessee's accounting profit as calculated after the application of IFRS 16 should be accepted for the purposes of DDD; therefore no adjustment needs to be made.

For the purposes of calculating the SDC on DDD, the adjustment to the lessee's reserves as of the 1st of January 2019 following the introduction of IFRS 16, should be recognized in the accounting profit and the necessary adjustments should be made.

Important points:

- For IFRS 9 and IFRS 15, the Implementing Guideline 15/2021 applies as from tax year 2018, whereas IFRS 16 applies as from tax year 2019.
- Any income tax returns for the years 2018 & 2019 that have not yet been submitted until the issue date of the Implementing Guideline 15/2021, must be submitted in accordance with the aforementioned provisions.
- Credit institutions that have already submitted their tax returns for the years 2018 & 2019 following a different tax treatment than the provisions of this Guideline, must submit revised tax returns. The same applies for persons

which are materially affected by reason of taking a different approach in the tax treatment compared to the provisions of the Guideline (e.g. group relief should be considered to have a material effect).

- Any person not falling into the above categories, can either submit a revised tax return or to incorporate the changes resulting from the implementation of this Guidance in their tax return of the following tax year.

For any clarification required, please feel free to contact us and we would be happy to assist.

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