Cyprus | Tax & Legal Services | 28 May 2021

Cyprus Tax News

Clarifications with respect to the tax treatment of the impact on the Financial Statements from the application of IFRS 9, IFRS 15 and IFRS 16

On 17 May 2021 the Tax Department issued Implementing Guideline 15/2021, providing clarifications with respect to the tax treatment of the impact on the financial statements from the application of IFRS 9, IFRS 15 and IFRS 16 for both Income Tax (IT) purposes and the calculation of Special Defence Contribution (SDC) on Deemed Dividend Distribution (DDD).

We provide below a summary of the main provisions of the Guideline with respect to the tax treatment of the aforementioned IFRSs. A summary table is also included at the end of this alert for easy reference (Appendix).

IFRS 9 - Financial Instruments

Effective for reporting years beginning on or after **1 January 2018**, IFRS 9 sets out how an entity should recognise and measure financial assets and financial liabilities. Its scope includes the recognition of provisions and impairment of receivables based on the expected loss model. IFRS 9 replaces IAS 39.

Tax treatment of provisions/impairment of receivables for IT purposes

The Guideline specifies that the tax treatment of provisions/impairment of receivables is governed by Article 9 (1) (c) of the Income Tax Law (ITL) which states that the following items are deductible for IT purposes (subject to conditions):

a) **bad debts** proved to the satisfaction of the Commissioner to have become irrecoverable during the year of assessment and actually **written off** during the same year notwithstanding that such bad debts were due and payable prior to the commencement of the said year, and

b) **specific provision for doubtful debts** in respect of which the Commissioner is satisfied that they have or will eventually become irrecoverable.

The Guideline goes on to provide more details on the circumstances and conditions that need to be satisfied to prove non-recoverability of a receivable amount.

As a result, in accordance with Article 9(1)(c) of the ITL, the tax treatment of provisions/impairments recognised under IFRS 9 is as follows:

Companies other than credit institutions

The application of IFRS 9 does not affect the tax treatment of write-offs/provisions of trade receivables that was applied by companies (other than credit institutions) up to tax year 2017. The tax treatment therefore remains as follows:

a) **Bad debt write-offs** will be **allowed** provided that the taxpayer proves that, despite any measures taken, and based on the specific facts, the receivables have become irrecoverable and were therefore written off.

b) **Specific** provisions for bad debts will be **allowed** provided that the taxpayer proves that, despite any measures taken, and based on the specific facts, there are objective difficulties in recovering the amounts.

c) **General** provisions for bad debts, that do not take into account the specific facts and circumstances of each case, are **not allowable**.

The Guideline further clarifies that, under IFRS 9, entities may apply the "simplified approach" and calculate expected credit losses on trade receivables only in cases that this amount is calculated on an **individual basis**. The amount calculated based on a provisions table/matrix which is prepared on a **collective basis** is not accepted.

Consequently, for the purposes of determining the taxable income of persons for tax years from 2018 onwards, the provisions/impairment of trade receivables recognised under IFRS 9 should be deductible to the extent that they represent items (a) and (b) above.

Finally, the amount of **the initial provision**, recognised on 1 January 2018 and recorded directly in the reserves as a result of the adoption of IFRS 9, **does not** generally **affect** the taxable income for the year **2018**. However, this provision may be deducted from the taxable income in any tax year, including the year 2018, in which the taxpayer proves that the conditions as per points (a) and (b) above are satisfied.

Credit institutions

IFRS 9 requires credit institutions to follow the “general approach” of recognising provisions/impairments on loans and other receivables, which results in three-stage provisions.

The tax treatment of provisions recognised under each of the stages is as follows:

a) Provisions relating to loans and receivables from customers who are classified in **Stage 1** (low credit risk) or **Stage 2** (significant increase in credit risk since initial recognition) are **not deductible** from the taxable income.

If during a year, a Stage 1 or 2 provision is reclassified to Stage 3 then any accumulated provision previously disallowed, together with the additional Stage 3 provision of the year, should be claimed as deductible in the tax computation of the year.

b) Provisions relating to loans and receivables from customers who are classified in **Stage 3** (credit impaired) or **POCI** (purchased or originated financial assets that are credit-impaired on initial recognition) are **deductible** from the taxable income.

   If during a year, a Stage 3 provision is reclassified to Stages 1 or 2, then any accumulated provisions that were previously treated as deductible should be added to the taxable income of the year.

The **initial provision** recognised by credit institutions on 1 January 2018 and recorded directly in the reserves as a result of the adoption of IFRS9, is **deductible from the taxable income** for the year **2018**, to the extent that it relates to loans and receivables from customers classified under Stage 3 or POCI. The necessary adjustment should therefore be made to the IT computation of 2018.

The **write-off** of loans and receivables from customers **are deducted** from the taxable income of the year, provided that the credit institution proves that, despite any measures taken, the specific loans or receivables **have become irrecoverable** and have therefore been written off.

Tax treatment of provisions/impairment of receivables for DDD purposes

According to the SDC Law, the profit on which SDC is imposed due to DDD is the profit as calculated in accordance with generally accepted accounting principles. As per the SDC Law, items arising from revaluation of securities and immovable property, should not form part of the accounting profit subject to DDD.

Given that provisions/impairment of receivables are not considered a revaluation for the purposes of the SDC law, **no adjustment** should be made to the profit for DDD purposes in respect of provisions/impairment of receivables recognised under IFRS 9.

The **initial provision/impairment of receivables** recognized on 1 January 2018 and recorded directly in the reserves as a result of the adoption of IFRS 9, is **deducted** from the accounting profit of the year **2018** (year of transition). The necessary adjustment should therefore be made to the DDD computation for the profits of 2018.

This treatment applies to all companies, including credit institutions.

IFRS 15 - Revenue from Contracts with Customers

IFRS 15 provides guidance on accounting for revenue from contracts with customers and is effective for reporting years beginning on or after **1 January 2018**. IFRS 15 replaces IAS 11 and IAS 18.

Tax treatment of IFRS15

The Guideline provides that the tax treatment of income recognised under IFRS 15 should be consistent with the accounting treatment, both for IT purposes and for the calculation of SDC on DDD. No adjustments should therefore be made to the IT and DDD computations.

The **initial adjustment to the reserves** on 1 January 2018 as a result of the adoption of IFRS 15, should **form part of the profit** of the year of transition (i.e. **2018**), both for IT purposes and for the calculation of SDC on DDD. The necessary adjustments should therefore be made to the IT computation of 2018 and the DDD computation for the profits of 2018.

It is noted that in case Circulars, Guidelines or Regulations have been issued governing the tax treatment of revenue recognition for specific sectors or types of income, these will **apply independently** of the accounting treatment based on IFRS 15.

<u>IFRS 16 - Leases</u>

IFRS 16 governs the accounting treatment of leases and is effective for reporting years beginning on or after **1 January 2019**. IFRS 16 replaces IAS 17.

The changes brought about by IFRS 16 are relevant for the lessee who needs to recognise all leases in the financial statements as finance leases as opposed to the previous treatment under IAS 17 where there was a distinction between finance and operating leases. Under IFRS 16, the lessor continues to distinguish between finance and operating leases in its books.

Tax treatment of leases for IT purposes

The application of IFRS 16 does not affect the tax treatment of leases and for the purposes of determining taxable income, the treatment that applied up to 2018 (as described further below) shall continue to apply. Consequently, the impact of IFRS 16 should be eliminated in the tax computation of the lessee.

The **adjustment to the lessee's reserves** on 1 January 2019 as a result of the adoption of IFRS 16, **does not affect** the taxable income for the year **2019**.

<u>Operating leases</u> (as interpreted for the lessor)

The lessee is entitled to a tax deduction for the **annual rent expense** (based on the accrual basis), which is the annual cost of using the leased asset, provided that the relevant asset is used for business purposes. The necessary adjustment should therefore be made in the tax computation to claim this deduction.

<u>Finance leases</u> (as interpreted for the lessor)

The lessee is entitled to **capital allowances** on the cost of the lease asset as well as any **finance cost** that relates to the lease. The necessary adjustment should therefore be made in the tax computation to claim the respective capital allowances.

Tax treatment of leases for DDD purposes

According to Article 3 (5) of the SDC Law, the accounting profit of the year for the lessee, as it arises after the application of IFRS 16, will be accepted for the purpose of calculating SDC on DDD. Therefore, **no adjustment** should be made to the accounting profit subject to DDD in relation to the accounting treatment of leases as per IFRS 16.

For the purposes of calculating SDC on DDD, the **adjustment to the lessee's reserves** on 1 January 2019 as a result of the adoption of IFRS 16, should be **incorporated in the accounting profit** of the year of transition (i.e. 2019). The necessary adjustment should therefore be made to the DDD computation for the profits of 2019.

Tax compliance clarifications

- The corporate and income tax returns for the years 2018 and 2019 that have not been submitted by the issue date of the Guideline, must be submitted in accordance with the provisions of the Guideline.

- Credit institutions that have already submitted their corporate tax returns for the years 2018 and 2019, and the tax treatment they have applied is not in line with the provisions of the Guideline, must submit a revised corporate tax return in accordance with the provisions of the Assessment and Collection of Taxes Law.

- Similarly, individuals and companies who are materially affected from the changes in the tax treatment resulting from the application of this Guideline are required to submit a revised tax return for the years 2018 and 2019.

- Any persons that do not fall within the above categories, have the right to submit a revised tax return for 2018 and 2019 in order to apply the provisions of the Guideline or incorporate any changes that arise from the application of the Guideline in the tax return of the next tax year.

How can we help?

We are at your disposal to provide clarifications for the above developments.

Appendix

IFRS 9 – FINANCIAL INSTRUMENTS		
ACCOUNTING ITEM	INCOME TAX TREATMENT	TREATMENT FOR DDD PURPOSES
Adjustment to reserves upon initial adoption	For companies other than credit institutions: No adjustment in the tax computation if the adjustment to the reserves represents provisions of a general nature. Tax deduction granted in the year the taxpayer proves non-recoverability of the respective amounts. For credit institutions: Tax deduction in tax year 2018 only for amounts representing Stage 3/POCI provisions.	Adjustment in the DDD computation for the profits of 2018
Provision for bad debts (simplified approach - trade receivables)	Deductible to the extent there is sufficient evidence of non-recoverability of the receivable amount in accordance with the provisions of the ITL.	No adjustment
Provision for bad debts (Stage 1) - Credit Institutions	Non-deductible	No adjustment
Provision for bad debts (Stage 2) - Credit Institutions	Non-deductible	No adjustment
Provision for bad debts (S3) - Credit Institutions	Tax deductible	No adjustment

IFRS 15 – REVENUE FROM CONTRACTS WITH CUSTOMERS		
ACCOUNTING ITEM	INCOME TAX TREATMENT	TREATMENT FOR DDD PURPOSES
Adjustment to reserves upon initial adoption	Adjustment in the IT computation	Adjustment in the DDD computation for the profits of 2018
Adjustments to revenue	No adjustment	No adjustment

IFRS 16 – LEASES (TREATMENT FOR LESSEE)			
ACCOUNTING ITEM	INCOME TAX TREATMENT FOR OPERATING LEASES	INCOME TAX TREATMENT FOR FINANCE LEASES	TREATMENT FOR DDD PURPOSES
Adjustment to reserves upon initial adoption	No adjustment	No adjustment	Adjustment in the DDD computation for the profits of 2019
Lease Depreciation (P&L)	Non-deductible	Tax deduction through capital allowances	No adjustment
Finance Cost (P&L)	Non-deductible	Tax deductible	No adjustment
Annual lease expense (accrual basis)	Tax deductible	n/a	No adjustment

Get in touch

© 2021 Deloitte Limited

This communication contains information, which is confidential. It is exclusively to the intended recipient(s). If you are not the intended recipient(s), please: (1) notify the sender by forwarding this email and delete all copies from your system and (2) note that disclosure, distribution, copying or use of this communication is strictly prohibited. Any erroneous disclosure, distribution or copying of this email communications cannot be guaranteed to be secure or free from error or viruses.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its global network of member firms, and their related entities (collectively, the "Deloitte organisation"). DTTL (also referred to as "Deloitte Global") and each of its member firms and related entities are legally separate and independent entities, which cannot obligate or bind each other in respect of third parties. DTTL and each DTTL member firm and related entity is liable only for its own acts and omissions, and not those of each other. DTTL does not provide services to clients. Please see www.deloitte.com/about to learn more.

Deloitte & Touche (M.E.) LLP (DME) is the affiliate for the territories of the Middle East and Cyprus of Deloitte NSE LLP ("NSE"), a UK limited liability partnership and member firm of DTTL.

Deloitte Limited, a private limited liability company registered in Cyprus (Reg. No. 162812) is the sub-licensed affiliate of Deloitte NSE for Cyprus. Deloitte Limited is among the leading professional services firms in Cyprus, providing audit & assurance, consulting, financial advisory, risk advisory, tax and related services as well as a complete range of services to international business through over 750 people in Nicosia and Limassol. For more information, please visit www.deloitte.com/cy.

Offices: Nicosia, Limassol

To no longer receive emails about this topic please send a return email to the sender with the word "Unsubscribe" in the subject line.