



February 27, 2015

Mr. Russell Golden
Chairman
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856

Re: Leases Project and the Accounting for Investment Tax Credits and Grants

Dear Chairman Golden:

We at the Equipment Leasing and Finance Association (ELFA) have been following the redeliberations of matters related to the *Leases* project. As the project nears completion, we believe the Financial Accounting Standards Board (FASB) should consider the lessor's accounting for investment tax credits (ITC) and cash tax grants in lieu of ITC in order to provide guidance in the final *Leases* standard regarding the lessor's accounting and reporting for such government incentives. We believe guidance is needed for entities that elect or have elected the deferral method of accounting for ITC. Absent consideration of this matter we believe significant controversy could arise and potentially result in either diversity in practice or changes to established practice without the benefit of open due process. We believe the FASB can readily address this issue by reviewing nature and purpose of ITC, the general concepts underlying the existing accounting guidance for the ITC, and the application of those concepts by today's lessors.

Since IFRS provides general guidance on the accounting for government grants in International Accounting Standard No. 20, *Accounting for Government Grants and Disclosure of Government Assistance* (IAS 20), we view this only as a US GAAP issue. We believe the recommended accounting discussed below would be consistent with accounting for ITC under IAS 20. We also believe the recommended accounting would be consistent with the existing guidance for ITC, which sets forth a preferable method and an acceptable alternative.

Background

While ITC is more targeted today than when initially addressed by accounting standards (currently limited in the U.S. to solar assets placed in service before 2017), its history shows ITC remains an important capital formation tool situationally used by the government to stimulate the economy or to support emerging technologies by lowering the cost of acquiring new assets. Accordingly, we believe it would be more efficient for the FASB to address this issue at this time, when guidance can be provided in the context of an active project on the accounting for leases.

ITC eligible assets may be acquired directly by an owner-user entity or by an owner-lessor. In either case, ITC serves to reduce the cost of fixed asset acquisition. For owner-users or operating lessors who have elected the deferral method, the net benefit of ITC is generally reported as a reduction of depreciable cost (preferable) or as a component of the tax provision (acceptable). For lessors who originate true leases accounted for as direct finance leases, the net benefit of ITC is either treated in a manner consistent with cost reduction or as a component of the tax provision. Under the cost reduction approach, ITC serves to create deferred income and offsets the reduction in unearned lease income arising from the lessor's pass through of a portion of the ITC benefit as a reduction in lessee rentals -- relative to non-ITC leases -- while still achieving an overall targeted net after-tax yield. In other words, deferred ITC income and unearned lease income are interdependent, or fungible in economic terms.

Lease Accounting and the Investment Tax Credit

We believe the deferral method of accounting for ITC should be neutral between owned and leased assets as it is for the "flow through" method. For owned assets, the benefit is generally accounted for as a reduction in the depreciable cost of the asset, resulting in an increase in an entity's pre-tax accounting income. For leased assets, we believe the accounting should be based on a similar net cost approach. For Type A leases, we believe the lessor should preferably account for ITC as a book basis reduction in initially recording the lease. While this results in the manifestation of ITC in unearned income, we believe its inclusion in earned income/pre-tax accounting income would not be in conflict with the revenue recognition standard. We believe this manifestation arises from the intended reduction in the acquisition cost of the asset. For Type B leases, the effect of ITC would preferably manifest itself in reduced depreciation expense. However, in either case, lessors could continue to report the tax benefit in the provision for income taxes, a reporting consistent with the "flow through" method of ITC.

While GAAP currently only addresses the accounting for ITC in the form of a tax credit, we do not believe the form of government incentives for new asset acquisitions, whether a tax credit or a cash payment in lieu of tax credit, should affect the accounting treatment. We note the U.S. government has allowed a cash payment in lieu of the tax credit in response to the 2008 recession due to the reduced supply of available tax equity, or a significant reduction in number of entities with sufficient taxable income to timely absorb the tax credits. We believe the substance of the government incentive is the same regardless of the form-- it is a cash flow arising from an investment in eligible property intended to reduce the cost of acquiring new assets.

If the accounting by lessors for ITC is not addressed, the difference in form may have implications for how the lessor's results of operations are presented in the financial statements. If the reduction in asset cost comes in the form of a grant, a lessor will appropriately report a higher yield or net interest margin on the leased asset if the lease is accounted for as a direct financing lease (DFL or Type A), or through the net operating margin (rents less depreciation) if the lease is accounted for as an operating lease (or Type B). If, on the other hand, the ITC is considered to be purely an element of the tax provision, then the operating metrics of the lessor will not be presented in a representationally faithful manner.

SFAS Statement No. 13, *Accounting for Leases*, did not provide general guidance on the accounting for ITC, but it did provide specific guidance on the accounting for ITC for leveraged leases.¹ Since ITC was prevalent at the time, practice in the financial service industry has evolved to allow for ITC to be accounted for as a component of lease revenue in DFLs. This reporting position was frequently used by lessors by analogy to leveraged lease accounting, which is a form of DFL accounting. This presentation has been important for bank and finance lessors as their periodic performance is generally measured by the net revenue from their investments. If the ITC were to be reported within the income tax provision, the lessor's investment in DFLs would appear to have a substandard yield, if not a negative yield in the case of current solar investments when the credit equals thirty percent (30%) of the acquisition cost.

Since the repeal of ITC for all equipment in 1986, preparers and their auditors have generally not had to consider this accounting issue. However, the reinstatement of ITC for alternate energy assets in 2008 and the addition of the new option of applying for a cash grant in lieu of a tax credit have made the matter relevant again. Absent contemporaneous guidance, interpretations have varied and have resulted in inconsistent treatment.

Need for Guidance

We believe the reporting of revenue on a lease with ITC or cash tax grants in lieu of ITC is only representationally faithful if, under the deferral method, ITC or cash tax grant in lieu of ITC is included as an initial period cash flow in determining the reportable implicit interest rate in the lease or separately reported as a source of lease income. While the absence of guidance in SFAS No. 13 was resolved through interpretation, we are concerned that in the existing regulatory environment a similar conclusion might not be reached unless this matter is explicitly addressed.

In summary, we believe there are three possible choices for the FASB to consider regarding the accounting for ITC and cash tax grants in lieu of ITC under the deferral method:

- *Account for the investment incentive as a net reduction to the initial book basis.* Under this method, the lessor would report an implicit interest rate in the lease consistent with the underlying legislative intent (cost reduction) and observable pricing (period zero cash flow). To the extent that claiming the ITC affects the initial tax basis of the asset -- as is currently the case (where the tax basis is reduced by 50% of the credit claimed) -- this approach should follow the existing guidance originally set forth in EITF Issue No. 98-11, *Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations*. This method of accounting would result in a normal relationship between the tax provision and pre-tax accounting income. Disclosure could be required to show the periodic effect of ITC.
- *Amortize the ITC based on the pattern of after-tax cash flows.* Under this method the after tax earnings from the lease would be amortized by solving for the net after tax yield and by separately allocating the unearned lease income and deferred ITC income based on the pattern of after-tax cash flows. Under this method, each lease would

¹ The accounting for the ITC is also excluded from the scope of Statement of Financial Accounting Standards No. 109, *Income Taxes*.

have a unique effective tax rate which would include the impact of ITC/tax grants and any related tax basis reduction. However, this method may be considered complex, and it might not otherwise be supported given its similarity to leveraged lease accounting.

- *Separate reporting of ITC as a discrete source of revenue.* Under this method, the ITC and cash tax grants in lieu of ITC, net of any related tax basis reduction, would be a separately reported revenue stream and amortized based on the implicit interest rate in the lease. Since such income would represent a permanent difference, the relationship between the tax provision and pre-tax accounting income would be unique in each reporting period and would require reconciliation.

While each of these alternatives would achieve a reasonable outcome, the first alternative would be preferable as it is consistent with existing practice and is easier for lessors to follow. We have prepared a detailed example of the accounting alternatives and would be pleased to share it with the FASB and staff, if further information on the accounting is necessary.

We appreciate the opportunity to provide our views on this matter. As always, we are pleased to provide additional information on this or other matters in connection with the FASB's redeliberation of the *Leases* project.

Respectfully Yours,

A handwritten signature in black ink, appearing to read 'WGS', with a stylized flourish extending to the right.

William G. Sutton, CAE
President and CEO

Attachment

Appendix

Leases and Investment Tax Credits Relevant Literature and Interpretations

Background

The authoritative guidance on the accounting for ITC has provided the basis for extending the implicit interest rate in the lease used for lease classification testing (a calculation where ITC is to be subtracted from fair value) to a lessor's reporting of ITC, where its basis reducing effect gives rise to reportable revenue. This extension is evident from practice publications.

General Publications

The following two publications provide a summary description of the reporting of ITC for DFLs, noting some financial institutions report ITC income as lease revenue:

1) Accountants' Handbook, Financial Accounting and General Topics

edited by D. R. Carmichael, O. Ray Whittington, Lynford Graham, 2007 edition

At Section 24.3d, this handbook states some financial institutions report ITC as lease revenue.

2) Credit Analysis of Financial Institutions

edited by Waymond A. Grier. 2007 edition

On page 277 this publication provides a summary description of how financial institutions account for ITC, noting that some institutions recognize ITC in lease revenue.

Technical Publications

PricewaterhouseCoopers' (PwC) *Accounting and Reporting Manual* and the AICPA's *Industry Audit Guide, Audit of Banks*, also address the reporting of ITC. PwC's interpretation recommends including ITC as component of lease revenue. The extract, below, is relevant as it ties the ITC to the lessor's implicit rate and the development of the accounting for ITC. It also refers to the AICPA guide:

4650.3111 Direct financing lease

The lessor in a direct financing lease uses the implicit rate (derived as discussed at [ARM 4650.1242](#)) in making the [FAS 13, par. 7d](#) test but must derive a different rate for amortization of unearned income if ITC is retained or if initial direct costs (which must be determined in accordance with [FAS 91, par. 6-7](#)) are incurred. As amended by [FAS 98, par. 22h-i](#), [FAS 13](#) defines certain terms for purposes of income recognition. The gross investment in the lease is the sum of the minimum lease payments (net of amounts related to executory costs) and the unguaranteed residual value. The excess of the gross investment over the cost or carrying amount of the leased property is unearned income. Initial direct costs, while not included in gross investment as defined, are included in the net investment in the lease. The unearned income and initial direct

costs shall be amortized to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease.

*The difference in rates used for classification and recording is most significant when the lessor retains ITC. ITC enters into the [FAS 13, par. 7d](#) test for classification, whereas the rules for recording are silent as to ITC, and unearned income as used in [FAS 13, par. 18b](#) excludes ITC. [FAS 13](#) deals only with amortization of unearned income, presumably because the Revenue Act of 1971 proscribed the mandating of a method of accounting for ITC. Conceptually, it might appear that, when ITC is retained by the lessor, the aggregate of unearned income and ITC should be amortized using the implicit rate since ITC, when available, is usually an integral part of the lease negotiations and since the implicit rate is used in the 90 percent recovery test of [FAS 13, par. 7d](#). This might require that the net investment in the lease be reduced by ITC retained, and the mechanical application of an interest method of amortization would be complicated by the fact that ITC is an after-tax item whereas the unearned income is a pretax item. Moreover, as discussed at [ARM 5790.223](#), the [FAS 109](#) methodology recognizes a portion of the after-tax benefit of deferred ITC in the deferred tax computation in the year it is generated. **We recommend that the lessor in a direct financing lease defer any ITC retained and that such credit be amortized to income over the lease term in relation to the net investment in the lease. Regardless of the method used, for balance sheet presentation unamortized ITC should technically be shown gross as a deferred credit, but the great weight of practice in the banking industry is to offset it against net investment. With respect to its presentation in the income statement, it may be presented as an element of income tax expense, or it may be included in revenue. The AICPA Industry Audit Guide, "Audits of Banks," recognizes this dichotomy in practice and merely recommends disclosure of the method followed.**[Emphasis added]*

This interpretation is also consistent with the interpretation included in the often quoted third edition of the Arthur Andersen's *Accounting for Leases*.

Similarly, PWC's tax accounting guide recommends accounting for cash tax grants in a DFL using the IAS 20 methodology (that is to amortize the grant to lease revenue using the interest method as the lease investment declines) per the following:

4.2.8.3 Grant accounting (updated October 2011)

*Determining whether government assistance should be subject to income tax accounting or another accounting model requires the use of significant judgment. If an entity determines that the governmental assistance does not fall within the scope of ASC 740 (and it is not considered an ITC) or ASC 605, Revenue Recognition, the entity should consider whether the governmental assistance is a governmental grant, (i.e., a credit can be received from a government entity without regard to taxable income). **While not specifically addressed in US GAAP, the accounting for government grants received has been addressed in International Financial Reporting Standards (IFRS) in International Accounting Standards No. 20, Accounting for Government Grants and Disclosure of Government Assistance, 5 which we believe is an appropriate model***

to follow. For a more complete discussion on grant accounting please see the government grants and other forms of assistance received section of the Accounting Manual.

Other

As previously noted in the extract from the PwC guidance, the lessor -- to compute the net present value of the minimum lease payments for purposes of determining its appropriate lease classification -- is required to use the implicit interest rate in a lease. The implicit rate in a lease is defined as the rate that, when applied to (1) the minimum lease payments and (2) the lessor's unguaranteed residual value, results in an aggregate present value equal to the fair value of the property at the inception date, less any investment tax credit retained and expected to be realized by the lessor. The method of recognizing revenue for a direct finance lease defined by the 1976 Board is as follows:

The difference between the gross investment in the lease (minimum lease payments plus the residual asset) and the sum of the present values of the two components of the gross investment shall be recorded as unearned income. The discount rate to be used in determining the present values shall be the interest rate implicit in the lease. The net investment in the lease shall consist of the gross investment less the unearned income. The unearned income shall be amortized to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease.

In order for the computations to work correctly when amortizing lease income, ITC must be included as a period zero lease payment and included in unearned lease income.