

LEASING 101

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Dear Technical Director:

RE: File Reference No. 2018-260:

My comment letter is written in reference to equipment leases.

I ask for the same accounting policy election allowed for sales tax to be applied to property tax and insurance for equipment leases that are triple net leases regardless as to whether the lessee pays the item or the lessor pays them and bills the lessee. Such payments are actually lessee costs and not lease payments. The reasons for my request are:

1 - There is legal ambiguity as to whether property taxes are a lessee or lessor cost - different municipalities have different rules as to who is liable for the taxes. Generally states use GAAP as a guide - so the lessee is the "property tax owner" of the asset for a lease classified as a finance lease (those are virtually always triple net leases too). Virtually all leases that are not daily rentals are triple net leases. Triple net leases transfer the obligation to pay taxes to the lessee whether the lease is a finance lease or an operating leases and some states respect the lease contract triple net terms. If no one pays the property tax the municipality will go after the lessor as a fallback threatening a tax lien and foreclosure BUT the lessor can sue the lessee for payment in a triple net lease as the lessee assumed the obligation contractually. The same ambiguity applies to insurance in a triple net lease as the lessee contractually agrees to the purchase insurance. I truly believe the 842 model needs to be modified to define these items as either lessee costs or lessor costs based on the terms of the lease contract. In a triple net lease these items are not lease payments.

2- Grossing up revenue and expense for sales tax, property tax and insurance does not give users useful info or info they are currently asking for. To my knowledge no users consider these items to be lessor revenue items whether paid directly by the lessee or if paid by the lessor and passed through to the lessee via a billing. Lessors do not consider these items revenue items (there is no profit element) and believe they are acting as an agent, not a principal when they pay the item and subsequently bill the

lessee. Current GAAP seems to be operating just fine. Grossing up distorts Operating Efficiency ratios used by investors and equity analysts to value financial institutions.

3- The amounts that would be grossed up for property taxes are insignificant to the P&L of a typical lessor. Insurance is rarely paid by the lessor and billed to the lessee as it only occurs when a lessee fails to provide evidence of insurance.

4- The administrative difficulty of determining amounts paid directly by lessees for these items would be unworkable as lessors have many thousands of leases in numerous municipalities. It would be a huge and costly effort for immaterial items that users do not consider revenue items.

In summary the grossing revenue and expense of lessors up for sales taxes, property taxes and insurance that the lessee agrees to be obligated for ignores legal substance, does not provide useful financial information, and creates a costly compliance exercise for items that are immaterial.

Sincerely,

A handwritten signature in black ink, appearing to read "J. J. Borew J.", written in a cursive style.

President, Leasing 101

Attachments:
Basis for comment letter positions
Questions for respondents

Basis for my comment letter positions:

Background

Jim Leisenring once told me that the reason topic 842 capitalizes leases that are executory contracts under the law is that the lessor has completed its performance obligation when it gives the lessee the keys and turns over control of the asset for the lease term. Under that "control" concept it would seem logical that costs of the asset that the lessee agrees to assume while it controls the use of the asset are their costs – not the lessor's costs. The terms of the lease contract should govern whether the costs are lessee or lessor costs. Costs that are lessee costs are lessee expenses, NOT lease payments. Jim Leisenring said topic 842 doesn't capitalize leases where the lessee returns the asset every day and the lessor has to perform again to redeliver the asset if the lease continues as those are truly executory. In the case of such short term rentals virtually all costs associated with the leased asset (like property taxes, DMV/FAA registration fees, inspection fees, maintenance, etc.) are lessor costs.

My position is that the 842 payment "model" that says that payments that a lessee makes to a lessor can only be a lease payment or a service payment must be revised. The model did not contemplate that in triple net leases lessors sometimes make payments on behalf of the lessee that are lessee costs and then the lessor bills the lessee as a "pass through payment". The lessor is acting as an agent in these cases as there is no profit element or mark up. The 3 types of these payments are sales tax, property tax and "force placed" insurance. In the case of sales tax the universal standard sales tax process for all businesses is for the lessor to bill sales tax to the lessee and then pay the tax to the municipality. Re property taxes although the lessee agrees to be obligated for property taxes, as a protective right to avoid a tax lien due to lessee default, the lessor often pays the tax and bills the lessee to pass the cost on (in some cases the lessor will allow lessees to pay directly when the lessee asks and if the lessee is a "good" credit). Re insurance, lessees agree to insure the asset for a casualty losses and liability while they control the asset under the terms of the lease but if they fail to provide evidence of insurance, the lessor "force places" the insurance and bills the lessee for the cost.

The terms of the lease contract should govern whether the costs are lessee or lessor costs. I ask the FASB to define lessee costs, as a defined term, as any costs the lessee contractually agrees to assume in consideration for obtaining the right to use and control the asset for the lease term. This would provide clear basis for judgement in concluding as to the nature of a payment by the lessee as either a lease payment, a service payment or a lessee cost.

Conforming to Topic 606

The decision to conform Leases to Rev Rec has led to problems when you get into the nitty gritty of different lease transaction types. There are unique issues with leases such

that the Leases standard should have been allowed to stand alone in dealing with lessor revenue issues. As one example, conforming to 606 has led to accounting for sale leasebacks with non-bargain purchase options to be “failed sales” yet the IRS and UCC recognize them as sales. The result is leaving an asset on the books of the seller/lessee that they do not own – this gives users an inflated picture of the assets of the preparer. I thought the idea that unique/complex transactions or industries should have separate GAAP was the way the Board first intended to go.

Legal Ambiguity

I think 842 has to define lessor costs and lessee costs based on that facts I present below. The Board should conclude that property taxes most often are a lessee cost not a lease payment or a service cost. If the Board does this it will eliminate the question of whether a lessor should gross up revenue and expenses when they pay property taxes on behalf of the lessee as they are expenses of the lessee.

Property taxes are typically lessee costs in equipment leases of one year or longer as the leases are typically triple net leases. In short term leases property taxes are lessor costs as those leases are not triple net leases. By contract, in a triple net lease, the lessee agrees be obligated to pay all taxes related to the lease and leased asset except for income taxes of the lessor. The lessee also agrees to be obligated for other things like repairs, maintenance, changing the oil, DMV inspections for vehicles, maintaining FAA airworthiness for aircraft, etc. These are also lessee costs by contract. In short term leases those costs are costs of the lessor because the term can be as short as one day.

Additionally, if you read the local tax rules for property tax absent the triple net terms that make the lessee obligated, the rules typically say the “owner” is liable (and the one who is assessed) and they use a risks and rewards framework, often referring to the GAAP lease classification, to determine the “owner”. So in Finance leases the lessee would be owner and assessed the tax. In an Operating lease, the lessor would be considered the owner and assessed the tax but would not be legally obligated to pay it if lease is a triple lease. I believe the fact that the lessee agreed to “triple net” terms means the property taxes are their cost even for operating leases that are triple net. I can provide a legal analysis of the issue of who is liable for property taxes from a lawyer who is a leasing specialist. If you proceed without a rules change then I think you have to deal with complexity, tax jurisdiction by tax jurisdiction, of who is the "owner" or obligor for property taxes in a Finance vs Operating vs Triple Net lease.

The whole reason why many lessors pay property taxes and bill the lessees (even though the lessee is obligated for the tax) is to avoid the lessee failing to pay the tax which results in a tax lien and possible a sale of the asset by the municipality in the worst case. They do the paying and billing as agent for the lessee and it is a pass thru with no profit element. The form of the payment process should not overrule the substance that the lessee is liable. Although it is not a perfect analogy, think of what mortgage lenders do - the same thing - they pay property taxes and bill the borrower via

an escrow process - there is no thought that this creates revenue and expense to be grossed up by the lender. The idea of paying the tax and billing the customer is a prudent business risk mitigant.

I have a hard time with rules that ignore the legal substance and I think this is one of those rules. A lease is like any other contract that strikes a bargain between the lessor and lessee. The lessor gives the right to use and control the asset for a period of time in exchange for the payment stream and the lessee assuming costs of the asset like taxes. If the lessee does not accept the obligation to pay taxes, the lessor would raise the rent by an estimate of future taxes and include a profit margin and a factor for uncertainty – but that is not the case in point, as then the lessor would take a principal's role in that case – not an agent's role.

Lack of Useful Information for Users

Users have not considered these items a lessor revenue and expense item – current GAAP operates just fine. Grossing up negatively impacts a lessor's "Operating Efficiency ratio" that equity analysts use to measure profitability of banks and finance companies. Adding the same amount to revenue and expense dilutes the ratio. In the real world accounting rules have business cost implications – the value of a finance company with a large leasing business vs one that does not have a leasing business would show the lessor to be less "efficient".

Insurance

I would make the same arguments as above that the insurance covers lessee risks and obligations that result from the use of the asset that they control for the lease term. In a triple net lease the lessee contractually agrees to insure the asset against casualty loss and insure their liability when using it as part of the economic bargain that is the lease contract. The only time lessors pay and bill for insurance is when it is "force placed" when a lessee defaults and fails to buy the insurance they agreed to buy. Lessors often require lessees to maintain liability insurance to protect the lessor from frivolous claims against the "deep pockets" lessor resulting from accidents while the asset is controlled by the lessee. Lessors often require lessees to maintain casualty insurance to protect the lessor's collateral value in the leased asset while it is in the possession and control of the lessee. Secured lenders also require borrowers to buy casualty insurance to protect the collateral to their loan yet we don't consider the insurance cost a lender's revenue and expense item.

Materiality

I also agree with Hal Schroeder that this is an immaterial issue for property taxes that has been a time sink for the Board and the staff. A materiality analysis is provided below that supports the estimate that grossing up for property taxes paid by the typical lessor preparer would add only about 1.87% to revenue and expense – an immaterial amount.

Materiality analysis – property taxes - gross up of revenue:

I estimate that grossing up revenue for lessor paid property taxes that are billed to lessees would increase revenue by only about 1.87%

Item	Impact	Net impact
Additions		
Property tax rates are generally about 1% applied to the depreciating cost over the IRS ADR life of the equipment. Lease implicit rates approximate 6% also applied to the declining lessor investment	+17%	
		+17%
Adjustments		
Lessors have other income including late charges, lessee fees and residual gains	-4%	-.
8 States do not charge tangible personal property taxes including large economy states like NY, NJ, Ill & Tx	-10%	-
Exemptions including government & tax exempt lessees, Ag equipment & other exemptions as incentives to attract business	-25%	
Applies only to Operating leases – lessors also do finance leases, term loans, working capital and floor planning loans to equipment dealers and franchise finance loans to franchisees	-40%	
Applies only to cases where the lessor pays the tax – does not apply to cases where the lessee pays directly	-10%	
Total adjustments		-89%
Estimated materiality % of lessor revenue		1.87%

Questions for Respondents

Sales Taxes and Other Similar Taxes Collected from Lessees

Question 1: Should a lessor's accounting for sales taxes and other similar taxes collected from lessees be aligned with Topic 606? If not, please explain why.

- No. These are not revenue items. They are "pass thru" items that the lessee agrees to be obligated for under the lease contract. The lessor is acting as an agent. There is no profit element. These are lessee costs in triple net leases. In daily rental contracts they may be lessor costs. Also in finance leases the lessee is considered the owner as the lease is considered a financed purchase. To deal with this issue and the legal ambiguity on a lease-by-lease basis, the FASB should define lessee costs and lessor costs and not treat lessee costs (whether paid by the lessor and then billed to the lessee) as a lease payment. The lessee agrees to be obligated for these costs as part of the negotiated lease contract that gives them control of the leased asset for the term of the lease. Leasing has unique issues that conflict with concepts in 606.

Question 2: Is the proposed accounting policy election, as written in this proposed Update, operable? If not, please explain why.

- Not completely. I would add the words property taxes and insurance specifically to avoid any confusion.

Question 3: Would the proposed accounting policy election result in a reduction of decision-useful information to users of a lessor's financial statements? If so, please explain why.

- Not at all, in fact quite the opposite. Users of financials do not consider these items revenue and expense of the lessor. Current GAAP works fine. The grossing up will dilute profitability. Equity analysts use the Operating Efficiency Ratio as a measure of profitability for financial institutions. The gross up would make lessors look less efficient.

Question 4: Should a lessor's accounting policy election for sales taxes and other similar taxes collected from lessees be applied to new lease contracts only or to all existing and new lease contracts? Please explain your rationale.

- Apply it to all because I think it misrepresents what revenue and expense are.

Certain Lessor Costs Paid Directly by Lessees

Question 5: Should a lessor be required to exclude certain lessor costs paid directly by lessees to third parties on behalf of a lessor as variable payments when the uncertainty in the amount is not expected to ultimately be resolved? If not, please explain why.

- My position is that the items in question are lessee costs as the lessee agreed to be obligated to these items in consideration for getting the right to use and control the asset for the term.

Question 6: Are the proposed amendments for the accounting for certain lessor costs operable? If not, please explain why.

- I would rather not get relief from an issue I think is wrong in principle. The correct amendment would be to include property taxes and insurance along with sales tax in the accounting policy election, if not change the “model” to define these as not lease payments but rather lessee costs.

Question 7: Would the proposed requirement for a lessor to not report certain lessor costs paid directly by a lessee to a third party on behalf of the lessor result in a reduction of decision-useful information to users of a lessor’s financial statements? If so, please explain why.

- Not at all, in fact quite the opposite. Users of financials do not consider these items revenue and expense of the lessor. Current GAAP works fine. The grossing up will dilute profitability. Equity analysts use the Operating Efficiency Ratio as a measure of profitability for financial institutions. The gross up would make lessors look less efficient.

Question 8: Should the proposed amendment in paragraph 842-10-15-40A to exclude certain lessor costs paid directly by lessees on behalf of a lessor as variable payments be applied to new lease contracts only or to all existing and new lease contracts? Please explain your rationale.

- Apply it to all because I think it misrepresents what revenue and expense are.

Recognition of Variable Payments for Contracts with Lease and Nonlease Components

Question 9: Would the proposed amendments clarify the application of paragraph 842-10-15-40? If not, please explain why.

- I disagree that these items are lease payments.

Question 10: Are the proposed amendments for the accounting for certain variable payments for contracts with lease and nonlease components operable? If not, please explain why.

I disagree with the idea that these items are lease payments.

Transition and Effective Date for Early Adopters

Question 11: How much time would be needed to implement the amendments in this proposed Update for an entity that early adopts Update 2016-02 before these proposed amendments are finalized? What transition method and transition disclosures should those entities be required to apply (provide)? Please explain your reasoning.

- No comment as I am not a lessor so I could not give an informed answer.

Question 12: Should the effective date for the amendments in this proposed Update be aligned with that of Update 2016-02? If not, please explain

- yes

