

Letter of Comment No: 5
File Reference: FSPFIN46RC

# Equipping Lease Professionals For Success

November 30, 2005

Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

Subject: FIN46(R)-c, Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R)

#### **Dear Technical Director:**

I am writing on behalf of the Equipment Leasing Association ("ELA") to provide comments to the Financial Accounting Standards Board ("Board") regarding the Proposed FASB Staff Position No. 46(R)-c, Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R). We welcome the opportunity to provide commentary and information on this proposed FSP.

A central part of the mission of the ELA and its Financial Accounting Committee is to provide educational information to the public as well as standards setters like the Board relative to data and analyses on leasing industry products, practices, and trends. Organized in 1961, the ELA is a non-profit association that represents companies involved in the dynamic equipment leasing and finance industry to the business community, government, and media. ELA's diverse membership consists of independent leasing companies, banks, captives, financial services corporations, broker/packagers and investment banks; as well as service providers like accountants, consultants, equipment managers, executive recruiters, insurance companies, lawyers, publishers, and software providers. ELA promotes the leasing industry as a major source of funds for capital investment in the U.S. and other countries. Headquartered in Arlington, Virginia, ELA is a national organization with more than 800 member companies and a staff of 25 professionals. In 2005, equipment leasing is estimated to be a \$213 billion industry.

We are writing this comment letter to request a change to Example 5. As we have noted in our recent liaison meetings with the Board and in our prior

comment letters, leases of the type described in Example 5 constitute about 1 percent of annual equipment leasing volume. Further, we are not aware of any diversity in practice in determining the variability to be considered in applying Interpretation 46(R) with respect to such leases. Accordingly, we do not believe that the proposed Example 5 represents a relevant example.

We support including a leasing example in the proposed FSP since approximately 30 percent of annual durable capital expenditures involve lease financing. However, we believe that the FSP should include a tax-advantaged lease ("tax lease") example. As we noted in our previous comment letter on uncertain tax positions, tax leases encompass about 40 percent of annual equipment leasing volume. Further, tax leases involving "big ticket" equipment assets (e.g., leases of aircraft and rail cars) are generally sponsored through special purpose entities, commonly through owner trusts, while leases of the type described in the proposed Example 5 are no longer sponsored through such vehicles. Finally, tax leases involve significant variability arising from tax and residual value risk and where the variability generally arises from the intertwined relationship of these risk attributes. Under U.S. income tax law, lessors are allowed the tax benefits incident to ownership (generally the tax benefits afforded by accelerated depreciation) if and only if they take a meaningful risk position in the leased asset, that is, by maintaining a meaningful equity interest (e.g., 15-20% of the initial fair value of the leased asset for leveraged leases) and a meaningful interest in the residual value (e.g., 15-20% of the initial fair value of the leased asset for long-term leveraged leases).

We have enclosed a proposed replacement lease example and related diagram for your review and consideration. We have attempted to use the same format and approach as used in the other examples. However, we note that, since tax leases involve unique features, a conformed example assumes that the reader will have a reasonable understanding of tax leases. Accordingly, we request that the FASB staff review the points below in deciding whether or not to expand or footnote our proposed replacement example:

- Owner trusts serve to divide legal and equitable ownership of the leased property. The trust holds title to or a leasehold interest in the leased property for the benefit of others. The division of legal and equitable ownership allows for broader participation and enhanced credit protections. It also serves as a means to facilitate participation by a trustee who performs important fiduciary duties in the day-to-day administration of the lease.
- The choice of a special purpose trust entity serves to resolve the competing commercial objectives of the parties. It provides a common ground solution.

 Lessors invest through owner trusts to broaden capital market participation, to facilitate transferability of ownership, and to limit liability.

Capital market participation. An owner trust permits financial institutions that by charter or policy may not hold a direct interest in the leased property. The trust may also serve to meet United States citizenship requirements for aircraft and vessels, thereby permitting non-US citizens to participate under certain conditions.

Transferability. A trust permits an owner participant to easily transfer its interest without re-documenting the transaction. The ability to transfer a "beneficial" interest serves to facilitate secondary market activity.

Limited liability. An owner trust may afford its owner participant with the same limitation of personal liability as a stockholder of a corporation. The trust may provide the owner participant with protection against its assets unrelated to the lease from becoming subject to a claim concerning breach of environmental law or tort risk arising in the lease transaction. Although the indemnity provisions of a lease generally place environmental and tort risks with the lessee, the trust by means of its separate legal existence may limit the potential damages if the lessee does not or cannot perform its lease obligations.

- Many lenders and lessees prefer to participate under an owner trust structure to avoid taking owner participant credit risk and to better protect their interests in bankruptcy. These participants are vitally interested in ensuring that there are no liens placed upon the financed leased asset that are extrinsic to the lease transaction and are not indemnified by the lessee. These participants want their claims to the leased assets to be free of the risks attendant to such liens. For this reason, they prohibit the trust from engaging in other transactions. Such a prohibition is clearly the most effective way to reduce the risk of loss arising from the placing of an unrelated lien upon the leased asset. By definition such a prohibition is impossible if the lessor is not a special purpose entity.
- A trust provides the participants with access to a fiduciary with specialized administrative expertise. The trustee generally serves at the direction of the owner participant. In addition to providing administrative services, including funds management, recordkeeping, reporting, and notifying services, trustees manage the activities of the trust with a high duty of care as established by trust law.
- The owner trust is disregarded as a separate entity for income tax purposes. The trust files an information return and reports the "flow through" of the tax benefits to the lessor (owner participant). Accordingly,

the owner trust does not impact the availability of tax benefits relative to a direct interest in the leased property.

- With the tax benefits scheduled in the pattern of future cash flows, the lessor (owner participant) expects to receive a significantly higher return than the debt holders. This higher return intends to compensate the lessor (owner participant) for taking tax and residual risk. If the lessor calculates its return on the basis of the pre-tax cash flows, its expected return generally would approximate the risk free rate.
- Since the lessor is allowed tax benefits based on the full purchase price (including the amount financed by nonrecourse debt), the lessor's exposure to loss is also leveraged in the event of foreclosure by the lender. For example, upon foreclosure, the owner participant must include any forgiven nonrecourse debt as taxable disposition proceeds even if it receives no cash proceeds or other consideration from the sale of the underlying leased asset.

We appreciate the opportunity to provide commentary on this proposed FSP and intend our example to improve its usefulness.

Sincerely,

Michael Fleming

Michael Fleming, CAE
President, Equipment Leasing Association

Enclosure

## Proposed Replacement Lease Example

## Example 5

A21. A bankruptcy-remote entity is created and financed with \$800 of 10-year fixed-rate debt and \$200 of equity from an investor. The entity uses the proceeds to purchase equipment to be leased to a lessee. The lease has a fifteen-year term and is classified for the entity as a direct finance lease, for the equity as a leveraged lease, and for the lessee as an operating lease. After the lease ends, the equipment will be sold or re-leased. The lessee has a one-time fixed-price purchase option to acquire the equipment at the end of the lease term at a price which is set above the forecasted value of the equipment. The transaction was marketed to potential debt investors as an investment in receivables of an obligor secured by the equipment and to an equity investor as a tax-advantaged investment in a subordinate component of the lease receivables and the residual value of the equipment. The equity tranche is designed to absorb all of the tax risk, most of the residual risk, and the first dollar risk of loss related to credit risk and fair value risk.

#### **Evaluation:**

A22. Step 1: Analyze the nature of the risks in the entity.

The entity is exposed to the following risks:

- a. Price risk with respect to changes in fair value of the underlying equipment (collateral) during the lease term
- b. Price risk with respect to changes in fair value of the equipment after the lease is scheduled to end
- c. Credit risk associated with possible default by the lessee.
- d. Interest rate risk associated with changes in the fair value of the lease receivables
- e. Tax risk associated with possible changes in the effective income tax rate and in the ability of the equity (owner participant) to efficiently utilize the tax benefits.

A23. Step 2: Determine the purpose for which the entity was created and determine the variability the entity is designed to create and pass along to its interest holders. The following factors should be considered in this determination:

- a. The entity was created to provide lease financing to the lessee.
- b. The entity was marketed to debt investors as an entity that will be exposed to changes in fair value due to collateral-secured credit risk of the lessee, with the equity tranche absorbing the first dollar risk of loss.

- c. The entity was designed to transfer all of the tax benefits of equipment ownership to the equity (owner participant) and to be a bankruptcy-remote issuer of non-recourse debt.
- d. The purchase option granted to the lessee is designed to give the lessee the ability to capture some of the price appreciation of the equipment if the fair value rises significantly above the expected value.
- e. The fair value of the fixed-rate debt will fluctuate due to changes in market interest rates. Because that variability is not directly caused by changes in the value of the entity's net assets exclusive of variable interests, it should not be considered when analyzing this entity.

Based on the above analysis, it can be determined that the entity was designed to create and pass along risk (e) in paragraph A22 to the equity investor and a portion of risk (b) to the equity investor and the remainder to the lessee through the purchase option. Risks (a) and (c) are designed to be passed first, to the equity investor and second, to the debt holders. The equity investor, debt holders, and lessee are all variable interest holders.

Example 5: Tax Lease, Debt, Equity

