

September 14, 2005

Letter of Comment No: 19
File Reference: FSPFAS13-A
Date Received:

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Proposed FASB Staff Position No. FAS 13-a
“Accounting for a Change or Projected Change in Timing of Cash Flows Relating to
Income Taxes Generated by a Leveraged Lease Transaction”

We appreciate the opportunity to comment on the Proposed FASB Staff Position No. FAS 13-a “*Accounting for a Change or Projected Change in Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease Transaction.*” When we consider current shortcomings in the rules based approach to lease accounting, the two most prevalent areas of criticism and concern are operating lease accounting by lessees and leveraged lease accounting by lessors. While the former is often criticized for the bright line determinations under which the lessee either reflects an asset and obligation on its books or simply accounts for the lease off-balance sheet, the concerns regarding leveraged leases deal with the netting of non-recourse debt and assets as well as the often favorable acceleration of lease income under the leveraged lease model. In addition, while leveraged leasing may have initially been envisioned to address fairly plain vanilla lease financings (e.g., a 20 year lease of an airplane with significant non-recourse funding) it has since evolved to include a variety of highly structured transactions that bear little resemblance to the originally contemplated lease financings (e.g., lease in, lease out transactions, sale in- lease out transactions and lessor interests in synthetic leases). As a result, we commend the FASB on its efforts to promptly address one of several issues that currently exist in practice related to leveraged lease accounting.

We agree with the proposed conclusions and amendments of FAS 13 noted therein subject to the following comments and suggestions.

Issue 1: The scope of this proposed FSP would apply to all transactions classified as leveraged leases in accordance with Statement 13. Do you agree that the scope of this proposed FSP should be limited to only leveraged lease transactions or should the scope be expanded to include all leases under Statement 13? Why or why not?

We agree that the proposed FSP should apply to all leveraged leases. We do not believe that a lease that is classified as other than a leveraged lease (e.g., a finance, operating or sales-type lease) should be eligible to qualify as a leveraged lease at a later date and the proposed FSP should explicitly acknowledge this. This does however raise a current practice issue – whether the extensions of a leveraged lease or a direct finance or sales-type lease, other than at or near the end of the lease term, can qualify as a leveraged lease. We would recommend that the final FSP specifically address this practice issue. We do however believe that the guidance for assessing the reclassification (as anything other than a leveraged lease) of existing sales-type, direct finance or operating leases is clear in FAS 13 and that unique issues of nonrecourse debt and timing of income tax cash flows only impact leveraged lease accounting.

Issue 2: This proposed FSP concludes that the timing of the cash flows relating to income taxes generated by a leveraged lease is an important assumption that should be accounted for in accordance with the guidance in paragraph 46 of Statement 13.

Additionally, this proposed FSP would require a leveraged lease to be reclassified if, at any time, a revision of an important assumption requires a recalculation of a leveraged lease and changes the characteristics of the lease in a manner that would have resulted in the lease not qualifying as a leveraged lease had the revised assumption been included in the original or most recent leveraged lease computation. Do you agree? Why or why not?

While we agree that the timing of cash flows related to income taxes is an important assumption in the leveraged lease model that should be accounted for in accordance with FAS 13.46, we are less supportive of requiring a reclassification of a leveraged lease at a later date unless the terms of the lease agreement have been changed or the non-recourse debt has been paid off. We would point out that EITF 86-43, *Effect of a Change in Tax Law or Rates on Leveraged Leases*, and FASB Technical Bulletin No. 79-16 (R), *Effect of a Change in Income Tax Rate on the Accounting for a Leveraged Lease*, did not mandate (or permit) a retest of a leveraged lease for a change in tax law or rate. It is unclear what if any impact the proposed FSP has on that EITF and Technical Bulletin. In addition, we believe the proposed FSP should scope out changes in assumption for a leveraged lease within the scope of FASB Interpretation No. 21, *Accounting for Leases in a Business Combination* (FIN 21) or alternatively note why the proposed FSP is not in conflict with that standard.

In lieu of the required reclassification, we would suggest that the FASB instead provide clarification on two requirements of a leveraged lease where significant diversity in practice exists – the requirement for substantial leverage in the form of non-recourse financing and the change in net investment.

- Substantial leverage - While we believe that the requirement that a long-term creditor provide sufficient non-recourse financing is commonly applied as a day one concept (e.g., generally accepted that 50% plus non recourse leverage at inception of the lease is appropriate), we have seen wide disparity in interpretations of the need for ongoing leverage. For example, in some leveraged lease transactions while the non-recourse financing is significant on day one, the debt is either short term in relation to the lease (e.g., a 20 year lease with 1-5 year debt) or the debt substantially amortized over a short term (e.g., although a portion of the debt is outstanding for 20 years only a minimal amount is outstanding after years 1-5). In some cases preparers believe as long as some portion of the debt is outstanding for some period (e.g., 1-5 years) the requirement is met while others would apply some formula based approach to determine a reasonable amortization over the lease term. Still other preparers believe the requirement for substantial leverage need only be met day one when the lease is classified (i.e., no ongoing requirement).
- Change in net investment - In addition, while we believe the requirement for the net investment to decline in the early years and increase in the later years is a substantial requirement (i.e., the decrease should be at least 10% of the initial investment and last for at least a quarter) we are aware of instances in which minor short term changes in the net investment have been viewed as meeting this requirement (e.g., the decrease in net investment associated with the first months lease payment).

While the Board may view these issues as minor, as can be seen by preliminary disclosures of some public companies of the impact of the proposed FSP, leveraged leasing involving non traditional leases is anything but minor.

Issue 3: This proposed FSP would require that the recalculation be based on actual cash flows that occurred up to and including the point of the actual settlement or expected settlement and the estimated cash flows thereafter. Additionally, this proposed FSP would require that the recalculation include any interest and penalties assessed or expected to be assessed by the taxing authority. Do you agree? Why or why not?

We agree that the recalculation should be based upon actual and anticipated cash flows. In addition, we do not object to the inclusion of interest and penalties in the leveraged lease model, however, we believe the proposed FSP needs a more detailed discussion of this issue including examples of how to account for the interest and penalties both as part of the cumulative effect of

adoption (elimination of accrual for interest and penalties as part of the cumulative effect adjustment) and on an ongoing basis (an acknowledgement that an interest and penalty accrual will only exist in the leveraged lease model versus as a separate balance sheet accrual).

We would, however, suggest the FASB decouple the FSP from the anticipated Uncertain Tax Positions Interpretation. While we understand the belief that tax accounting should be consistent, we would point out that leveraged leases are specifically excluded from FAS 109, *Accounting for Income Taxes*, and that the estimated timing of income tax cash flows should be reflected in leveraged lease accounting simply at the best estimate of such cash flows. This would be consistent with the accounting for other estimates under leveraged lease accounting (e.g., residual values) and would not, in our view, create an inconsistency in tax accounting that does not already exist under FAS 109. This change would also enable the proposed FSP to become effective despite delays in the Uncertain Tax Position Interpretation.

We also have the following comments:

- Paragraph 9 of the proposed FSP notes that "... the expected timing of income tax cash flows generated by a leveraged lease transaction shall be reviewed annually or more frequently if events or changes in circumstances indicate that a change in timing is **probable** of occurring." It is unclear from this statement whether a lessor would be required to continue to use the cash flows under the original leveraged lease accounting until they are probable of changing (i.e., less than a 30% chance of staying the same) or if a revised projection of cash flows were more likely than the original if the revised cash flows would instead trigger a rerun. We believe the appropriate answer would be to rerun when the best estimate of the timing of cash flow changes.
- Footnote 4 of the proposed FSP includes the following discussion of a tax opinion:
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A tax opinion is external evidence supporting a management assertion, and the decision to obtain a tax opinion is a matter of judgment to be exercised by management in evaluating the weight of all available evidence and the uncertainties of the applicability of the relevant statutory or case law or of the Service's assertions.

While we do not disagree with the discussion noting the decision to obtain a tax opinion is matter of management judgment, we believe the discussion that a tax opinion is external evidence supporting management's assertion is overly simplified and often incorrect. In our experience it is not unusual for management and a company's auditor to disagree with the conclusion in a third party adviser's tax opinion letter. In addition, we believe the issue of tax opinions as accounting evidence is an issue better left to the FASB's Uncertain Tax Positions project.

- Paragraph 11 of the proposed FSP “If, at any time, a revision of an important assumption requires a recalculation of a leveraged lease and changes the characteristics of the lease in a manner that would have resulted in the lease not qualifying as a leveraged lease had the revised assumption been included in the original **or most recent leveraged lease computation**, the lessor shall reclassify the leveraged lease as a direct financing lease on a prospective basis as of the date the change in assumption occurs.” It is unclear to us what the most recent leveraged lease computation is. Since a leveraged lease determination is made at the inception of the lease it is unclear why the “most recent leveraged lease computation” would also be factored in. We do, however, agree that the retest should include all changes since inception of the lease.
- We also believe the proposed FSP should address situations in which a taxpayer makes a payment to the taxing authority that, although not designated in correspondence with the tax authority as relating to a particular issue, is specifically made by the taxpayer to stop interest from accruing on a leveraged lease exposure. We believe that in that instance the leveraged lessor should reflect that payment in its leveraged lease cash flows.

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

Ernst + Young LLP