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September 12, 2005

Mr. Lawrence Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: FSP FAS 13-a—Accounting for a Change or Projected Change in the Timing of Cash Flows Relating to Income Taxes Generated by a Leveraged Lease

Dear Mr. Smith:

Citigroup is pleased to have the opportunity to comment on the proposed FSP FAS 13-a ("FSP"). We are generally supportive of the guidance provided in the FSP. We recognize that this FSP is an amendment of FASB Statement No. 13, *Accounting for Leases*, and believe that the guidance presented will provide a more accurate representation of the underlying economics of leveraged lease transactions.

#### Scope

We support limiting the scope of this FSP to only those leases classified as leveraged leases in accordance with Statement 13 due to the unique nature of leveraged lease accounting. The leveraged leasing model is unlike the models used to account for direct financing, sales-type, and operating leases in that it is directly derived from cash flows received and paid. The same cannot be said of a simple direct financing, sales-type, or operating lease. Limiting the scope of the FSP to leveraged leases is also consistent with the Board's earlier decisions on this topic. If the scope of the FSP were to be expanded we would expect additional deliberation and due process to consider the additional practice issues such an expansion might create.

## Recalculation

We support the requirement to recalculate a leveraged lease due to a <u>significant</u> change in the timing of cash flows relating to income taxes generated by a leveraged lease.

The inclusion of changes in timing – and of interest and penalties – in a recalculation creates significant operational challenges, because the recalculation is dependent on both the expected outcome and timing of settlement. As an example, as of December 31, 2005, an enterprise may assume that it will make a payment of \$100 in June 2006. In the first quarter of 2006, further settlement or litigation discussions may occur and the enterprise may revise its expectations such that it expects to pay the \$100, plus the related additional interest, in August 2006. A literal reading of the FSP would require a second recalculation in the first quarter of 2006. Any



adjustment to the expected payment date, no matter how trivial, would require the recalculation of the related leveraged lease. If each small change in timing of cash flows (and perhaps the inclusion of small amounts of additional interest) results in a recalculation of the leveraged lease, we are concerned that the proposed FSP could effectively require leveraged leases to be recalculated every reporting period until any uncertainty is resolved. In such circumstances, we do not believe that the marginal benefit of frequent recalculations to users of financial statements outweighs the costs that would be incurred by enterprises to recalculate an entire portfolio of leveraged leases on a regular basis.

We encourage the Board to incorporate a "significance" concept with respect to recalculation of a leveraged lease due to the change in timing of cash flows and a change in the net income of the lease attributable to the inclusion of interest. We acknowledge there is currently no such concept in paragraph 46 of Statement 13 as it relates to changes in total net income. However, changes in net income (and, therefore, recalculations) are relatively rare in current practice. The changes proposed by the FSP would represent a dramatic change and changes in the timing of tax cash flows may be much more common. For example, cash payments are routinely made to the IRS after the close of an audit for a certain tax period. Thus, even after a settlement has been reached with the IRS, the timing of that cash payment to be incorporated in the leveraged lease recalculation may vary significantly due to the factors entirely unrelated to the leveraged lease, including other outstanding audit issues or the timing of the filing of an amended tax return. Given the uncertainties of litigation and settlement of the leveraged lease issues and the other unrelated factors, we expect that a lessor's best estimate of the timing of tax payments may vary frequently. The overall concept of materiality is not useful to mitigate this concern, because a recalculation may be necessary to document and support the conclusion of immateriality. This obviously provides no relief to the operational complexity associated with recalculation. However, we believe that the inclusion of a significance concept in the FSP itself will alleviate the significant operational challenges of implementation while achieving the Board's goal of ensuring that significant changes to the economics of a leverage lease are appropriately recognized in the lessor's financial statements.

Judgment will be needed in order to determine what constitutes a "significant" change in the timing of cash flows. We believe this required judgment is consistent with principles-based standards and slight differences among lessors in judgment on what is "significant" will not produce materially different financial reporting results.

# **Cash Flows**

We support the requirement that any recalculation be based on actual cash flows up to the point of recalculation, and estimated cash flows thereafter, as this method reflects the economic reality of the cash flows paid and received during the term of a leveraged lease. This is also consistent with recalculation of a leveraged lease due to a change in expected net income – the cash flows used for periods before recalculation are the actual cash flows received.



## Interest and Penalties

Current practice requires that an enterprise recognize interest and penalties when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated in accordance with FASB Statement No. 5, Accounting for Contingencies. Upon adoption of this FSP, interest and penalties (expected or incurred) related to a leveraged lease will be recognized as part of the effective tax rate of the leveraged lease. Thus, the portion of the interest and penalties attributable to pre-tax income prior to the date of adoption will be recognized through the cumulative catch-up and the portion attributable to future income will be recognized prospectively through a higher effective tax rate. This will require an enterprise that has already accrued for interest and penalties with respect to a leveraged lease transaction to reverse the accrual previously established, partially offsetting the income statement expense associated with the recalculation.

While we recognize the inclusion of interest and penalties in the recalculation may produce the counterintuitive result of spreading the interest and penalty expense over the entire lease term rather than accrued when paid, we agree with the FASB that the inclusion of interest and penalties in the recalculation is more conceptually sound than accounting for interest and penalties related to a leveraged lease separate from the lease.

### Reclassification

Paragraph 9 of Statement 13 provides the following guidance on reclassification of an existing lease:

If at any time the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 7 and 8 had the changed terms been in effect at the inception of the lease, the revised agreement shall be considered as a new agreement over its term, and the criteria in paragraphs 7 and 8 shall be applied for purposes of classifying the new lease.

Existing guidance does not require or allow a lease classification to be changed due to a change in assumptions. For example, paragraph 8a of Statement 13 requires an assessment of the collectibility of payments. However, subsequent estimates of credit impairments would not change the original classification. We believe that the guidance for reclassification of leases should be consistent, regardless of lease-type, and do not believe that reassessment of lease classification due to changes in estimates is an improvement to existing guidance. We believe current practice — to reassess classification only upon a change in contractual arrangements between the lessor and lessee as required by paragraph 9 of Statement 13 — is appropriate.

If the Board does determine that a change in estimates or conditions outside of the lease agreement should cause subsequent reevaluation of leveraged lease classification, it seems reasonable that this view should be applied consistently. Current interpretations in practice do not allow a direct finance lease to be reassessed as a leveraged lease after inception. However, if the Board believes it is conceptually appropriate to revisit leveraged lease classification after



inception, it seems appropriate to us that the classification should be reassessed in both directions.

# Interaction with Proposed Interpretation on Uncertain Tax Positions

We believe that the reference in the FSP to the Proposed Interpretation, Accounting for Uncertain Tax Positions (the "Interpretation"), is unnecessary and problematic. We believe that the tax cash flows incorporated into the leveraged lease upon adoption of the FSP should be based on an enterprise's best estimate, rather than the probable recognition threshold and measurement standard that has been introduced in the Interpretation. We see at least two significant conceptual and practical issues with the current proposal.

We note that the guidance in the Interpretation is not yet finalized and has not been thoroughly vetted in practice. As an example, at least one large accounting firm has asserted that "it would be difficult to reconcile a conclusion that the lessor's filing position would be sustained upon audit based on its technical merits, with an estimated settlement in which the lessor concedes approximately 60 percent of the amount in dispute." Thus, those accountants would require that the leverage lease calculation assume 100 percent disallowance of tax benefits, even if that lessor may be very near a settlement at that 60 percent level.² It makes no sense to us to record a transition adjustment outside of operating earnings, assuming no tax benefits, when a second (and positive) income adjustment will likely be recognized as an adjustment to interest income, perhaps in a matter of months. This result is simply not informative or useful to financial statement users.

Second, a view must be taken on the *timing* of the cash flows, which is largely dependent on a lessor's expectation of settlement and closing of an audit period with the IRS or on the resolution of litigation. These estimates are obviously extremely judgmental and based on factors largely outside of the lessor's control. But they also may be directly dependent on the amount of the settlement. For example, a lessor is more likely to engage in a very protracted appeal and litigation process before agreeing to a 100 percent disallowance of tax benefits. In contrast, a lessor may agree to a more favorable settlement much more quickly. We believe that the estimates of amount and timing must therefore be made in tandem and consistently. If a lessor's best estimate is for a quick resolution with a favorable settlement amount (that calls into question a "probable" assertion), it seems inconsistent to us to require that the lessor incorporate its *timing* 

<sup>&</sup>lt;sup>1</sup> We do not necessarily agree with this broad assertion given the specific facts and circumstances.

<sup>&</sup>lt;sup>2</sup> It is also unclear to us even if the lessor has reached a settlement agreement with the IRS whether that settlement provision constitutes a new "tax position" that may be separately assessed immediately, or whether the affected tax returns must actually be amended and filed with the IRS to be respected as the new tax position. If the latter view is taken, even those tax benefits specifically agreed upon with the IRS may not be able to be recognized if the agreed upon benefits differ significantly from the original filing position. This issue could be resolved if the FASB incorporated the concept in paragraph 8c of the proposed Interpretation on Uncertain Tax Positions in the FSP's transition guidance, so that resolved tax matters would be treated as if they had met the "probable" threshold.



estimate, but be forced to assume 100 percent disallowance, because that combination of timing and amount would not have been agreed to yet.<sup>3</sup>

Therefore, we ask the Board to remove both the reference to the Interpretation and any requirement that the tax benefits related to a leveraged lease be "probable" of being sustained. Rather, the FSP should require lessors to use their best estimate of the most likely amount and timing of tax cash flows in all recalculations of leveraged leases, and to incorporate new estimates when there has been a significant change. This would allow the Board to de-link these projects and issue this FSP while it continues to deliberate the Interpretation.

#### **Effective Date and Transition**

We agree with the proposed effective date and transition. While the recalculation of leveraged leases is complex and requires significant judgment, we believe that the necessary resources can be devoted to this analysis as long as the final FSP is issued in September and is sufficiently clear. If the final issuance is delayed beyond September or if unresolved interpretative issues exist, we would have concerns that the appropriate analysis could not reasonably be performed and reviewed prior to the issuance of financial information for calendar-year end companies. In that case, we still believe the Board should issue the FSP in final form as soon as possible so that lessors who choose to adopt the FSP prior to its required effective date may do so.

\* \* \* \* \*

We thank the Board for its consideration and would welcome the opportunity to further discuss this matter with Board members and their staff. Please do not hesitate to contact me at (212) 559-7721 or Bret Dooley at (212) 816-0572.

Sincerely,

Robert Traficanti

Vice President and Deputy Controller

Robert Trafficanti &

Citigroup

<sup>&</sup>lt;sup>3</sup> We note this is a relatively unique issue, because for most uncertain tax positions, the timing of the resolution does not affect the financial reporting of those amounts, since most tax liabilities are evaluated and presented on an undiscounted basis.