

Letter of Comment No: **15**
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Date Received:

September 12, 2005

Mr. Lawrence Smith
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

RE: File Reference No. 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:

PricewaterhouseCoopers LLP appreciates the opportunity to respond to the Financial Accounting Standards Board (FASB or the "Board") on its proposed FASB Staff Position (the proposed "FSP") noted above. We support the issuance of the proposed FSP because we believe it will improve accounting for changes in the timing of cash flows in a leveraged lease transaction and reduce diversity in practice. We support the overall notion that changes in the timing of cash flows should result in a recalculation of a leveraged lease. The cash flows relating to income taxes are a significant component of leveraged lease calculations and, thus, we believe that the recalculation will allow the accounting to better reflect the economics of the transaction in a model based upon the time value of money.

Our additional comments regarding the proposed FSP are as follows.

Re-qualification as a Leveraged Lease – The proposed FSP would change practice by requiring that a lease re-qualify for leveraged lease accounting each time that a recalculation is performed. The re-qualification would consist of a determination that, using the most recent cash flow assumptions, the lessor's net investment, since inception of the lease, still declines and rises (that is, it reflects the required "down-and-up" pattern). If the lease fails to re-qualify, it would be reclassified as a direct financing lease and accounted for as if it had been classified as a direct financing lease since inception. This re-qualification would also be required for a recalculation triggered by a change in the estimated total net income from the lease.

We believe that the proposed FSP should not require re-qualification of a leveraged lease at each recalculation date. Paragraph 9 of FASB Statement No. 13 (FAS 13), *Accounting for Leases*, has been used in practice to determine when a leveraged lease should be reclassified, and we believe that guidance continues to be appropriate. Moreover, we observe that, while FASB Interpretation No. 21 (FIN 21), *Accounting for Leases in a Business Combination*, uses a nontaxable transaction as its sole example, the example does not reflect a decline and rise in the acquirer's net investment

in the acquired leveraged lease. Yet, the acquirer is required to carry forward the target's classification as a leveraged lease. Paragraph B13 of the FSP explains "that because leveraged leases receive ... special accounting treatment, a lessor should be required to reevaluate the classification of a leveraged lease when a recalculation of that lease is required to be performed." This seems to suggest that leveraged lease accounting is merely being tolerated. The Board may perhaps intend to eliminate leveraged lease accounting in the future; however, we believe it would be inappropriate to "chip away" at leveraged lease accounting in such a piecemeal fashion. While we agree that there is no conceptual basis to limit a requirement to re-qualify to a change in timing of cash flows, the introduction of a new requirement to re-qualify would extend the scope of the proposed FSP beyond what was originally intended, as evidenced by the title of the proposed FSP and the introductory paragraph, which refer only to a change in timing of income tax cash flows.

Income Tax Threshold –We refer you to our letter in response to the request for comment on the Exposure Draft of a proposed FASB Interpretation (the proposed FIN), *Accounting for Uncertain Tax Positions*. In that letter, we set forth our view that the threshold for determining whether tax benefits are recognized should be if the preponderance of the available technical evidence weighs in favor of the reporting entity. This approach, which we believe would better reflect economic expectations with respect to uncertain tax positions, would result in a recognition threshold that is closer to a "more likely than not" threshold. If that approach is adopted, we agree that derecognition should occur if and when it becomes "more likely than not" that the tax position would not be sustained upon audit. If our suggested approach for recognition is not adopted and the Board continues with an asset/contingent-asset based approach, we would propose that derecognition occur only when loss of the tax benefits becomes probable.

Even if the approach that we recommended with respect to the proposed FIN is not adopted, we believe that a similar approach should be considered with respect to the proposed FSP. FASB Statement No. 109 (FAS 109), *Accounting for Income Taxes*, recognizes that the time value of money is an important element in the leveraged lease accounting model. Accordingly, income taxes relating to leveraged leases were excluded from the scope of FAS 109 in paragraph 9c. We believe that a reporting entity's best estimate of expected cash flows should be used in the recalculation provided that a more likely than not threshold is met with respect to whether the tax position would be sustained upon audit. The implications of recognizing and derecognizing tax benefits in connection with a transaction not involving a leveraged lease are often limited to the amount of income tax expense recognized. On the other hand, in a leveraged lease, the implications would extend to (1) the amount of pretax leveraged lease income recognized, (2) the amount of tax expense recognized, and (3) if the final FSP reflects the conclusions reflected in the proposed FSP, whether the lease re-qualifies as a leveraged lease. We believe that these differences should be carefully considered when the Board redeliberates whether the thresholds used in the proposed FIN should be the same thresholds used for the proposed FSP. We do not believe the accounting would reflect the economic substance of the transaction if the "probable" threshold is retained as the transition threshold for recognition of uncertain tax benefits in a leveraged lease, and, solely as a result of the transition threshold, the lessor would be required to recalculate the leveraged lease with the assumption that none of the expected timing benefit would be realized.

FIN 21 and Acquisitions – A number of entities have acquired lessors with pre-existing “Lease-In—Lease Out” (LILLO) arrangements in business combinations. Alternatively, some entities have purchased a portfolio of leases, including LILLOs, in asset acquisitions (that is, they did not constitute businesses). Leveraged leases acquired in asset acquisitions have typically been accounted for in a manner similar to the manner described in FIN 21—based on the estimated cash flows of the buyer from the acquisition date forward. The interaction of the proposed FSP with FIN 21 raises a number of questions. For example, does the Board intend that the proposed FSP apply to leveraged leases acquired either within the context of a business combination or asset acquisitions? If so, should estimated back taxes due be recorded within the context of the proposed FSP or as a separate liability in purchase accounting? We believe that they should be recorded as a separate liability in purchase accounting. Does the Board intend that an entity that previously applied FIN 21 to acquired leveraged leases be required to re-qualify those leases? We do not believe that this would be appropriate. FIN 21 clearly ignores the cash flows enjoyed by the seller in accounting for the acquired leveraged lease. If, however, it is the Board's intention that an acquirer of a lessor re-qualify each leveraged lease, the proposed FSP should clarify this intent and indicate how the determination should be made. For example, should it be based on the seller's cash flow estimates, as adjusted for the current changes in important assumptions? As indicated above, we believe that the proposed FSP should not require a re-qualification.

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Appendix I includes responses to the specific questions included in the FSP, as well as certain editorial comments. If you have questions regarding our comments, please contact Ted Baran at (973) 236-7226.

Sincerely,

PricewaterhouseCoopers LLP

Appendix I

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 believe that a lease can be classified as a leveraged lease only at inception and, once a lease ceases to qualify as a leveraged lease, it cannot subsequently be reclassified as a leveraged lease. Thus, we agree that the scope of the FSP should be limited to leveraged lease transactions. We would find it troubling if leases could flutter in and out of leveraged lease accounting and recommend that any inequity that might be caused by a permanent loss of leveraged lease accounting as a result of changes in the estimated timing of tax benefits be dealt with by eliminating the re-qualification requirement.

While we agree that the scope of the FSP should not be limited to LILOs and SILOs, it is not clear that it should be applied to leveraged leases that were acquired. As indicated in the attached letter under the caption "FIN 21 and Acquisitions," there are significant implementation issues in the context of an acquisition. Moreover, the accounting of the acquirer should not be impacted by the cash flows that the lessor experienced prior to the acquisition. Accordingly, we recommend that the FSP not require a re-qualification of acquired leveraged leases.

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?

We agree that the timing of cash flows relating to income taxes is an important assumption that should be accounted for in accordance with paragraph 46 of FAS 13. We do not agree that a lease should be required to maintain the "down and up" pattern in the net investment in order to re-qualify for leveraged lease accounting. See the related discussion in our attached letter.

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 calculations should be based on actual or expected cash flows. This would cause the accounting to reflect the economics expected to be realized from the transaction.

However, there is a fair amount of confusion over what is meant by the words used in the proposed FSP. We encourage the Board to clarify exactly what it meant. See our editorial comments below.

We also agree that the recalculation should include interest and penalties. This inclusion would be consistent with the notion that the previous calculation was done in good faith, using the best estimates at the time. We also agree that the recalculation should include interest and penalties “expected to be assessed by the taxing authority”; such amounts would be the best estimates of the cash flows that would occur. It appears that such amounts would differ from the amounts that would be recognized under the proposed FIN if the minimum threshold for recognition is not met. The proposed FIN would require interest “based on the difference between the tax position recognized in the financial statements and the amount previously claimed or expected to be claimed in the tax return.” The difference seems to be an acknowledgement that expected cash flows should be used in a leveraged lease model, even if those expected cash flows would not warrant recognition within the scope of the proposed FIN.

Following are other editorial comments:

- 1) The title of the proposed FSP should be revised if the requirement to re-qualify as a leveraged lease is not limited to situations in which there is a change or projected change in the timing of tax cash flows.
- 2) The first sentence of paragraph 3 should be modified to read: “Paragraph 44 of FASB Statement No. 13 ... requires the lessor in a leveraged lease to recognize income at a level rate of return on its net investment in the lease in those periods in which the net investment is a positive amount.” As indicated later in paragraph 44, the income is allocated between a pretax lease income component and a tax effect of the pretax lease income component.
- 3) In paragraph 4 of the FSP, the penultimate sentence should conclude: “...and reducing the overall expected rate of return.”
- 4) The fifth sentence of paragraph 9 has given rise to much confusion. While the sentence as drafted is accurate based on the intention of the FSP, a number of readers who do not understand the intention have interpreted the sentence differently. We recommend that the proposed FSP be very explicit as to how the calculation is to be done. One way of modifying the sentence would be as follows: “The recalculation shall include (1) actual cash flows up to the date of the recalculation, (2) projected cash flows between the date of the recalculation and the date of any future expected settlement (these would typically continue to reflect the position previously taken on the tax return as filed), (3) a projected settlement payment at the date of the future projected settlement, and (4) projected actual cash flows following the date of the future projected settlement.”
- 5) Consistent with the previous comment, the sixth sentence of paragraph 9 should be modified to read: “Additionally, the recalculation shall include at the projected payment date the projected amount of any interest and penalties expected to be paid.”

- 6) The penultimate sentence of paragraph 9 as drafted implies that all changes should be reflected in income from continuing operations “before income taxes.” However, this is inconsistent with FAS 13 and with current practice. Paragraph 46 of FAS 13 refers to Appendix E for the accounting for the change. Schedule 7 of Appendix E correctly segregates the change between the pretax effect and the tax effect of the cumulative adjustment. Only the pretax effect is shown in pretax income; the tax effect is shown in income tax expense. Accordingly, the words “before income taxes” should be deleted from the sentence.
- 7) A question arises as to whether interest and penalties included in the recalculation should be reflected in pretax income or in tax expense. We would observe that the proposed FIN allows entities to continue to classify interest and penalties either “above the line” or in income tax expense. The issue has not previously been a practice issue in leveraged lease accounting because, as noted in footnote 3 of the proposed FSP, “interest and penalties had been excluded from the recalculation prior to the issuance of this FSP.” At the same time that leveraged lessors record a cumulative adjustment to reflect the recalculated leveraged lease, they will be releasing into income liabilities that they had previously recorded for interest and penalties on leveraged leases. We believe that the proposed FSP should require that lessors be consistent in their classification (pretax or income tax expense) of interest and penalties between leveraged leases and other uncertain tax positions. To do otherwise, would permit an entity to release a pre-existing liability against pretax income while recording the corresponding effect within leveraged lease accounting in income tax expense.
- 8) Footnote 5 should be clarified. It is our understanding that a settlement with the Internal Revenue Service normally results in one or more adjustments to taxable income with respect to each tax year. The actual payment of back taxes results from flowing the adjustments through the applicable tax returns. While a penalty may be assessed with respect to a particular transaction, interest is normally calculated based on the total amount of underpayment of tax for each tax year. Accordingly, we recommend that the footnote be reworded as follows: “The recalculation should reflect an allocation to the leveraged lease of back taxes paid or expected to be paid as a result of the actual or expected adjustments to taxable income of each applicable tax year due with respect to the leveraged lease transaction. The recalculation should also reflect a reasonable allocation of the total interest payable between the leveraged lease transaction(s) and other tax exposures that are settled concurrently.”
- 9) The words “or most recent leveraged lease computation” in the first sentence of paragraph 11 of the FSP have caused some confusion. Consistent with comment 4 above, we recommend that the sentence be modified as follows: “If, at any time a revision of an important assumption requires a recalculation of a leveraged lease and the recalculation does not result in the lessor’s net investment declining and then rising as per paragraph 42d of FAS 13, the lessor shall reclassify the leveraged lease...”

- 10) Consistent with comment 6 above, the last sentence in paragraph 11 should be modified to read: "The gain or loss shall be included in income from continuing operations in the same line items used when leveraged lease income is recognized."