

## EITF ABSTRACTS

Issue No. 86-33

**Title:** Tax Indemnifications in Lease Agreements

**Date Discussed:** October 16, 1986

**References:** FASB Statement No. 13, *Accounting for Leases*  
FASB Statement No. 29, *Determining Contingent Rentals*  
FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*  
FASB Technical Bulletin No. 85-3, *Accounting for Operating Leases with Scheduled Rent Increases*

### ISSUE

Some leases contain indemnification clauses that indemnify lessors, on an after-tax basis, for certain tax benefits that the lessor may lose if a change in the tax law precludes realization of those tax benefits.

The issue is the appropriate accounting by the lessor and lessee for indemnification payments.

### EITF DISCUSSION

The Task Force reached a consensus that, although the indemnification payments may appear to meet the definition of contingent rentals in Statement 13, as amended by Statement 29, such payments are not of the nature normally expected to arise under contingent rent provisions. Further, due to the close association of the payments to specific aspects of the tax law, the payments should be accounted for in a manner that recognizes the tax law association. The original lease classification should not be changed.

Lessors receiving indemnification payments should allocate the payments into two parts: (1) that resulting from any investment tax credit (ITC) lost and (2) that relating to all other tax effects. The portion relating to ITC should be accounted for consistent with the lessor's

accounting policy for ITC. That is, the payments allocated to the ITC cost should be recognized in the income statement in the same period as the ITC would have been recognized. The Task Force, however, did not discuss how the payments would be classified in the income statement. The remaining part should be reflected in income consistent with the classification of the lease. That is, the payments should be accounted for as an adjustment of the lessor's investment if the lease is a capital lease or recognized ratably over the lease term if an operating lease.

Consistent with the accounting for nonlevel rents under Statement 13 and Technical Bulletin 85-3, lessees with operating leases would account for the payments as additional expense ratably over the remaining lease term irrespective of when they are made. Lessees with capital leases should adjust the basis of the leased asset. [Note: See STATUS section.]

## **STATUS**

Interpretation 45, which was issued in November 2002, requires a guarantor to recognize, at inception of the guarantee, a liability for the obligation undertaken in issuing the guarantee. The Interpretation also elaborates on the disclosures to be made by a guarantor.

The accounting by the lessee (guarantor) under this consensus for the indemnification suggests that no initial liability would be recognized at the inception of the lease. That accounting is nullified by paragraph 3(c) of Interpretation 45, which requires recognition of a liability at inception of the lease (which is also the inception of the indemnification clause) for which the measurement objective of that initial recognition is the fair value of the lessee's obligation under the indemnification agreement. Furthermore, the Interpretation requires expanded disclosures.

No further EITF discussion is planned.