

**FASB Meeting Handout
March 2, 2005**

Leveraged Lease Accounting

At the November 10, 2004 Board meeting, the Board decided that a change in the timing alone of tax benefits expected to be realized from a leveraged lease should result in a recalculation of the leveraged lease as described in paragraph 46 of FASB Statement No. 13, *Accounting for Leases*. The staff will present the following questions to the Board at this meeting:

Issue 1: What threshold or scope limitation, if any, should be incorporated into the guidance for determining whether a recalculation should be performed for a change in the timing of the realization of tax benefits? Should the guidance be limited to LILO and SILO transactions? Should the types of changes in the timing of the realization of tax benefits exclude those relating to AMT and NOL carry forwards?

Issue 2: If the Board decided that a threshold should be incorporated into the guidance, should the guidance for determining whether a recalculation should be performed for a change in amount of estimated net income be consistent?

Issue 3: Does the Board affirm its previous decision that a change in the timing of the realization of tax benefits from a leveraged lease should require a recalculation of the leveraged lease?

Issue 4: Does the Board affirm its previous decision that a change in the realization of tax benefits from a leveraged lease should require a reevaluation of the classification of the leveraged lease?

Issue 5: In what form should this guidance be issued? *Issue 6:* What should be the appropriate transition method for this guidance? *Issue 7:* What should be the appropriate effective date for this guidance?

ISSUES

Issue 1: What threshold or scope limitation, if any, should be incorporated into the guidance for determining whether a recalculation should be performed for a change in the timing of the realization of tax benefits? Should the guidance be limited to LILO and SILO transactions? Should the types of changes in the timing of the realization of tax benefits exclude those relating to AMT and NOL carry forwards?

Scope Limitation

LILO/SILO

At the November 10, 2004 Board meeting, Board members discussed whether to limit the scope of this project to “LILO” (lease-in/lease-out) transactions and “SILO” (sale-in/lease-out) transactions. The FASB staff does not believe such a scope limitation should be incorporated into the guidance. Although the most significant impact currently will likely stem from “LILO” and “SILO” transactions, there may be other types of leveraged lease transactions in the future where a change in timing of the tax benefits will occur. Limiting the scope to these types of transactions would effectively “scope out” other types of leveraged lease transactions. In order to alleviate any concerns regarding potential future transactions, the staff believes the scope of this project should

include all transactions that are classified as leveraged leases under the provisions of Statement 13. ***THE BOARD AGREED***

AMT/NOL

The FASB staff believes only changes in important assumptions that are directly related to the leveraged lease and change the timing of the tax benefits expected to be realized should require a recalculation and these important assumptions should not include timing as a result of AMT and NOL carry forwards. ***THE BOARD AGREED: THIS IS NO DIFFERENT THAN EITF 87-8, MEANING NO RERUN IF THE AMT OR NOL WILL REVERSE. IF THE AMT OR NOL DO NOT REVERSE, THE RESULT IS A CHANGE TO TOTAL NET INCOME REQUIRING A RERUN.***

Threshold Issue

The FASB staff is presenting three views regarding a possible threshold. The term *any important assumption* as used in each of the views presented below may exclude AMT and NOL carry forwards depending on the Board decision on Issue 1. The views for the Board to consider are as follows:

- *View A:* Any important assumptions affecting the timing of the realization of tax benefits from the lease shall be reviewed at least annually. If during the lease term, the revision of an important assumption changes the timing of the realization of tax benefits from the lease, the rate of return and the allocation of income to positive investment years shall be recalculated from the inception of the lease following the method described in paragraph 44 of Statement 13. The accounts constituting the net investment balance shall be adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed.
- *View B:* Any important assumptions affecting the timing of the realization of tax benefits from the lease shall be reviewed at least annually. If during the lease term, the revision of an important assumption that affects the timing of the realization of tax benefits results in a more than minor change in the timing of estimated total net income from the lease, the rate of return and the allocation of income to positive investment years shall be recalculated from the inception of the lease following the method described in paragraph 44 of Statement 13. A “more than minor change” is based on whether the gain or loss in the year the assumption is changed is equal to or greater than 10% of the net income recognized to date from the leveraged lease transaction. The accounts constituting the net investment balance shall be adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed.
- *View C:* Any important assumptions affecting the timing of the realization of tax benefits from the lease shall be reviewed at least annually. If during the lease term, the revision of an important assumption that affects the timing of the realization of tax benefits results in a more than minor change in the timing of the estimated total net income from the lease, the rate of return and the allocation of income to positive investment years shall be recalculated from the inception of the lease following the method described in paragraph 44 of Statement 13. A “more than minor change” is based on whether the gain or loss in the year the assumption is changed is equal to or greater than 10% of the total net income expected to be recognized from the leveraged lease transaction. The accounts constituting the net investment balance shall be adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed.

The FASB staff recommends View A.

THE BOARD AGREED. MATERIALITY IS LEFT AS A JUDGEMENT ISSUE BETWEEN PREPARERS AND THEIR AUDITORS. THE BOARD DID NOT WANT TO ESTABLISH BRIGHT LINE TESTS. THE DECISION TO CHANGE GAAP IS DUE TO THE SIZE OF THE ADJUSTMENTS TO RETURNS AND THE SENSITIVITY TO LILOS/SILOS AS TRANSACTIONS UNDER SCRUTINY. THE DISCUSSION FOCUSED IN PART ON THE NEED TO INCLUDE QUALITATIVE CONSIDERATIONS IN THE ASSESSMENT OF MATERIALITY.

Issue 2: If the Board decided that a threshold should be incorporated into the guidance, should the guidance for determining whether a recalculation should be performed for a change in amount of estimated net income be consistent? *NOT AN ISSUE AS THEY DECIDED NOT TO INCORPORATE A THRESHOLD.*

Issue 3: Does the Board affirm its previous decision that a change in the timing of the realization of tax benefits from a leveraged lease should require a recalculation of the leveraged lease? *YES, THE BOARD AFFIRMED THIS.*

Issue 4: Does the Board affirm its previous decision that a change in the realization of tax benefits from a leveraged lease should require a reevaluation of the classification of the leveraged lease? *YES, THE BOARD AFFIRMED THIS. LEVERAGED LEASE ACCOUNTING IS DIFFERENT (“SPOOKY”) THAN ANY OTHER ACCOUNTING, WITH TAX ASSUMPTIONS SO IMPORTANT. THEREFORE, THE CLASSIFICATION RULES SHOULD BE TESTED WHENEVER THERE IS A CHANGE IN CASH FLOWS.*

Issue 5: In what form should this guidance be issued? The FASB staff believes there are two possible forms that the guidance for this project may be issued: (a) as an amendment to Statement 13 or (b) as a Board-directed FSP. The FASB staff recommends this guidance be issued in the form of an FSP because of the need for narrow and limited revisions to Statement 13 (specifically paragraph 46) and the fact that there is precedence for issuing FSPs to amend existing standards. ***THE BOARD AGREED. THE BOARD ACKNOWLEDGED THAT THIS DECISION IS AN AMENDMENT TO FAS 13 BUT IT IS VERY NARROW. THERE IS PRECEDENT FOR AN FSP TO AMEND GAAP. THE FSP IS HIGHLY FOCUSED ON ONE ISSUE THAT DOES NOT AFFECT MANY PREPARERS. THE BOARD INSTRUCTED THE STAFF TO REACH OUT TO THE ELA AND PREPARERS WHO ARE LILO/SILO LESSORS AS THEY ARE DRAFTING THE FSP. THE ELA WILL RECEIVE A COPY DURING THE DRAFTING PROCESS, PRIOR TO ITS PUBLIC RELEASE. THE FSP PROCESS IS EASIER FOR THE BOARD AND STAFF. THERE WILL BE A 60-DAY COMMENT PERIOD, WITH ISSUANCE EXPECTED IN ABOUT A MONTH. FSP IS EXPECTED TO BE FINALIZED IN THE THIRD QUARTER.***

Issue 6: What should be the appropriate transition method for this guidance?

The staff believes that there are three transition methods for the Board to consider:

- *View A:* This guidance shall be applied prospectively to revisions in important assumptions that result in changes in timing of the realization of tax benefits from leveraged lease transactions. Earlier application of this guidance, including retroactive application to all leveraged leases

regardless of when the revision in the important assumption occurred, is encouraged but not required.

- *View B:* Accounting changes adopted to conform to the provisions of this guidance shall be applied retroactively.
- *View C:* An entity shall recognize the cumulative effect of initially applying this guidance as a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, *Accounting Changes*. The amount to be reported as a cumulative-effect adjustment in the statement of operations is the difference between the amount of net income from leveraged leases recognized in the statement of financial position since lease inception prior to the application of this guidance (under the provisions of Statement 13) and the net income from leveraged leases that would have been recognized in the statement of financial position since lease inception pursuant to this guidance. Leveraged leases shall be reclassified pursuant to this guidance as of the effective date of this guidance. Earlier application of this guidance is encouraged but not required.

The FASB staff recommends View C.

THE BOARD AGREED. THE ONLY GOOD NEWS IN ALL THIS IS THAT THE CUMULATIVE-EFFECT ADJUSTMENT IS “BELOW THE LINE” ON THE INCOME STATEMENT, IN EFFECT, RECYCLING “ABOVE THE LINE” EARNINGS. AT THE MEETING THE DECISION AS TO WHEN TO RECOGNIZE THE RECALCULATION WAS UPON SETTLEMENT WITH THE IRS. AFTER THE MEETING, THE ELA DISCUSSED THIS POINT WITH STAFF AND WERE TOLD THAT THE BOARD MAY CHANGE ITS POSITION TO RERUN WHEN THE SETTLEMENT IS PROBABLE. THIS WOULD BE IN LINE WITH FAS 5 AND THE BOARD’S THINKING ON THE UNCERTAIN TAX POSTION PROJECT THAT IS IN PROGRESS. THE BOARD REJECTED “GRANDFATHERING” SO AS NOT TO PUT LESSORS WHO HAVE YET TO SETTLE IN AN UNFAIR POSITION.

Issue 7: What should be the appropriate effective date for this guidance?

The staff is presenting three effective dates for the Board’s consideration:

- *View A:* This guidance shall be effective for the first reporting period beginning after the date the guidance is finalized.
- *View B:* This guidance shall be effective for fiscal years beginning after December 15, 2005 (January 1, 2006, for calendar-year end enterprises).
- *View C:* This guidance shall be effective for fiscal years ending after December 15, 2005 (December 31, 2005, for calendar-year end enterprises).

If the Board decides that View A is the appropriate transition method (that is, prospective treatment), the FASB staff believes the effective date should be based on View A since no additional time would be needed to recalculate leveraged leases for past changes in the timing of tax benefits. If the Board decides that either View B or View C is the appropriate transition method, the FASB staff believes the effective date should be based on View C since this provides adequate time to perform the necessary recalculations. ***THE BOARD CHOSE VIEW C.***