Property Tax Implications of Lease Accounting GAAP Changes

John C. Ramirez

Lease obligations in the United States total in the trillions of dollars. The majority of these lease obligations are classified as operating leases for financial accounting purposes. Under current U.S. GAAP, the assets and the liabilities of operating leases are not recorded on the lessee's balance sheet. The IASB and the FASB are proposing significant changes to the current lease accounting standards. As a result, virtually all leases, including operating leases, will be reported on a lessee's balance sheet. The effect of the proposed lease accounting change could have a significant impact on the property tax valuations of many industrial and commercial taxpayers. Taxpayer companies with substantial leasing activity should be prepared (1) to assess how the proposed GAAP changes will affect their financial statements and operations and (2) to analyze the impact of the proposed GAAP changes on future lease transactions. This discussion summarizes the proposed lease accounting changes and considers the property tax implications of the proposed GAAP changes.

Introduction

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (referred to in this discussion as the "Boards") are moving to a convergence of international and U.S. generally accepted accounting principles (GAAP).

As part of the GAAP convergence project, the accounting standards setters are proposing changes to resolve a long-standing difference in U.S. versus international lease accounting GAAP.

For more than 30 years, under U.S. GAAP, the lease assets and the lease liabilities categorized as operating leases were not recorded on the lessee's balance sheet. Under the proposed lease accounting GAAP changes, all leased assets and related lease liabilities will be recorded on the lessee's balance sheet.

The effect of the proposed lease accounting GAAP change may have a significant impact on the property tax valuations of many industrial and commercial taxpayers.

This is particularly true for capital intensive taxpayers that lease many of their real estate and personal property assets. Such taxpayers would include railroads, airlines, pipeline companies, telecom companies, electric companies, and others.

The proposed GAAP changes (1) differ significantly from the current lease accounting GAAP, and (2) affect all lessee financial statements. Accordingly, it is important that corporate taxpayers, property tax assessors, and property tax valuation analysts understand the proposed changes.

This discussion summarizes the proposed changes to lease accounting GAAP and considers the property tax implications of the proposed changes.

Valuation Implications

The proposed changes are an important part of the IASB/FASB accounting standards convergence project. The proposed changes differ significantly from current lease accounting U.S. GAAP.

And, most importantly, the proposed changes will require taxpayer companies to report all lease obligations, including operating lease obligations, on the taxpayer's balance sheet. This change in accounting principles may cause many capital-intensive taxpayers to report increased levels of assets and liabilities.

The proposed GAAP changes are designed (1) to simplify lease accounting standards and (2) to improve the quality and comparability of financial information.

The proposed GAAP changes are intended to increase the transparency of information in financial statements about the amounts, timing, and uncertainty of the cash flow that relates to lease contracts.

The proposed GAAP changes will affect all lessee financial statements. Therefore, the proposed GAAP changes may affect the property tax valuations for both (1) lessee taxpayers subject to unit principle assessments and (2) lessee taxpayers subject to summation principle assessments.

The proposed GAAP changes may also affect business and property valuations performed for gift and estate tax, income tax, collateral values, debt covenant compliance, bankruptcy (solvency/insolvency), shareholder litigation, family law, and many other purposes.

Accounting Principles Background

In 2001, the IASB and the FASB began a joint project to develop a new approach to lease accounting ("the IASB/FASB Leases Joint Project"). The current proposed GAAP changes are part of the IASB/FASB Leases Joint Project.

The IASB is an independent, privately funded, international accounting standard-setting board. The IASB was founded on April 1, 2001, as the successor to the International Accounting Standards Committee (IASC).

The IASB is responsible for the following:

1. Developing International Financial Reporting Standards (IFRS)
2. Promoting the use and application of these IFRS reporting standards

The FASB was established in 1973 for the purpose of establishing and improving the standards of financial accounting and reporting for nongovernmental entities in the United States. Consistent with that purpose, the FASB maintains the *FASB Accounting Standards Codification* (ASC).

The ASC represents the source of U.S. accounting and financial reporting standards. These standards are officially recognized as authoritative by the Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA).

The objective of the IASB/FASB Leases Joint Project is to develop a new approach to lease accounting that would ensure that all lease-related assets and liabilities are reported consistently in lessee and lessor financial statements.

To achieve this objective, the IASB and the FASB jointly developed draft guidance on lease accounting. Currently, the Boards are proposing a new IFRS and new amendments to the *FASB Accounting Standards Codification* (the "proposed changes").

The purposes of the proposed changes are (1) to simplify lease accounting standards and (2) to improve the quality and comparability of lessee and lessor financial information.

To achieve these purposes, the IASB and FASB are proposing changes to the current lease accounting standards that provide a more complete and accurate portrayal of a company (including a taxpayer corporation) leasing activity.

These changes would require the lessee taxpayer to report relevant information about lease obligations, including the amounts, timing, and uncertainty of cash flow generated from lease activity. This information would make it easier for financial statement users to determine the financial position, operating capacity, leverage, and return on capital of the lessee taxpayer.

The IASB and the FASB are proposing changes to lease accounting standards for two reasons:

1. The changes will bring U.S. GAAP closer to international GAAP.
2. The current accounting standards need improvement to provide investors and other financial statements users with a more complete picture of a lessee's leasing activities.

Under the current standards, financial statements may not reflect the complete picture of many lease transactions. This is because, under the current accounting standards, similar lease transactions may be accounted for in different ways. This difference may make it difficult for financial

statement users to compare taxpayer entities that have made different leasing decisions.

Current Lease Accounting Standards

The problem with the current standards is that U.S. GAAP—and the equivalent International Accounting Standards (i.e., IAS 17 *Leases*)—have two lease categories:

1. Capital leases (referred to as “finance leases” under IAS)
2. Operating leases

And, the current accounting treatment of these two lease categories is significantly different. The lease categorization is based on various factors described later in this discussion.

In general, if a lease is classified as a capital lease, then the lease-related assets and liabilities are reported on the lessee’s balance sheet. However, if the lease is categorized as an operating lease, then the lessee is not required to report any assets or liabilities on the balance sheet.

The lessee simply accounts for the operating lease payments as an expense over the lease term. As a result of the different accounting treatment for operating leases and capital leases, financial statement users have to estimate the effects of operating leases when calculating a company’s financial and operational metrics.

There are greater differences in the reported information in relation to lessees than lessors. However, the Boards believe that it is important to have consistent accounting for both lessees and lessors.

Therefore, the proposed GAAP changes will establish one method of lease accounting for all lease contracts. The Boards believe that a single method of lease accounting would produce more complete and comparable financial reporting.

And, a single method of lease accounting would reduce the opportunity to structure financing transactions to achieve a desired accounting outcome.

The following discussion focuses on the proposed lease accounting GAAP changes from the lessee taxpayer’s perspective.

Significance of the Proposed GAAP Changes

Leasing is an important part of the financing activities for many taxpayer companies. This is because lease financing is a substitute for secured debt financing.

And, as with secured debt financing, the consequences for the failure to make timely lease payments is the same as the failure to make secured debt payments: The lessor becomes a creditor, and it can force the lessee into bankruptcy.[1]

Lease obligations in the United States are currently estimated to total in the trillions of dollars.[2]

Examples of some taxpayer leased property that commonly qualify for operating lease treatment under the current lease accounting standards include the following:

1. Airplanes
2. Real estate
3. Railroad locomotives and railcars
4. Automobiles and trucks
5. Equipment

These leased properties represent significant long-term obligations for many taxpayer companies. The majority of these lease obligations are classified as operating leases. Therefore, under the current lease accounting standards, these lease obligations are not reported on the lessee taxpayer's balance sheet.

The treatment of operating leases under the current accounting standards presents a challenge for some financial statement users. This is because some financial statement users, and in particular property tax valuation analysts, may need to estimate the effect of operating leases on a taxpayer's leverage and other financial ratios.

Under the current standards, this can be a challenging task. This is because the current accounting standards may not capture the economics of a taxpayer's operating lease activity. That is, the current lease accounting standards allow the assets and liabilities of operating leases to bypass the lessee taxpayer's balance sheet.

The proposed on-balance-sheet treatment of leases means that financial statement users would no longer need to estimate the effects of operating leases when calculating lessee taxpayer financial metrics such as leverage ratios. Under the proposed new lease accounting standard, taxpayer financial statements may provide users with a more complete view of a lessee taxpayer's assets, liabilities, and future cash flow.

Operating Leases and Capital Leases

The current accounting standards have two lease categories:

1. Capital leases (or, finance leases under IFRS)
2. Operating leases

The current accounting treatment for a capital lease is basically the same as if the taxpayer lessee had borrowed money to buy the asset. The leased asset and the related liability are reported on the lessee taxpayer balance sheet.

The initial value of the asset and the liability is the lower of the fair value of the leased asset or the present value of future lease payments. And, the lease interest expense and depreciation (if any) are reported on the lessee taxpayer income statement.

The current accounting treatment for an operating lease is basically the same as if the lessee taxpayer had rented the asset. That is, if a lease transaction meets the requirements of an operating lease, then the leased asset and the related lease obligation are not reported on the taxpayer's balance sheet.

And, only the rent expense (i.e., the operating lease payment) is reported on the taxpayer's income statement.

Under current U.S. GAAP, a lease that meets any one of the following four requirements is classified as a capital lease:

1. Ownership of the leased asset transfers to the lessee at the end of the lease.
2. The lease contains a bargain purchase option.
3. The lease term is 75 percent or more of the economic life of the leased asset.
4. The present value of lease payments equals 90 percent or more of the fair value of the leased asset.

Because of the defined accounting standards used to distinguish between an operating lease and a capital lease, a lessee may be able to structure a lease to avoid meeting any of the four capital lease requirements. In other words, small differences in the terms of the lease arrangement may affect whether the leased assets and liabilities are reported on the lessee's balance sheet.

The distinction between operating leases and capital leases makes it a challenge for financial statement users to compare different entities and the implications of different leasing decisions.

This is because the current operating lease accounting treatment (1) results in differences in reported assets and liabilities between lessees operating similar assets, and (2) allows the lessee to structure the lease agreement (as either an operating lease or a capital lease) to achieve a particular accounting outcome.

Summary of the Proposed Changes to Lease Accounting

The IASB and the FASB are proposing one accounting standard for all lease contracts. As a result, virtually all leases will be reported on a lessee taxpayer's balance sheet.[3]

The balance sheet of a lessee taxpayer would include both

1. an intangible asset, representing the right to use the leased asset (referred to as the "right-of-use asset") and
2. a liability for the obligation to make lease payments resulting from the lease contract.

The initial measurement of the lease obligation and the right-of-use asset would be reported as the present value of the expected lease payments. The present value of the lease payments would be estimated based on an estimate of

1. the lease term (which would include options to extend or terminate the lease) and
2. lease payments (which would include variable lease payments, such as contingent rent, and any residual value guarantees).

The discount rate used to estimate the present value of the expected lease payments would be the lease interest rate charged to the lessee, if readily determined, otherwise the lessee's incremental borrowing rate (at the lease commencement date).

Lessee taxpayers would reassess the lease term and lease payments estimates at each reporting date. Changes to the estimated lease term would adjust the related right-of-use asset and lease obligation. And, changes due to variable lease payments and residual value guarantees would be reflected

1. in income, if they relate to past or current periods and
2. to the right-of-use asset, if they relate to future periods, with a corresponding adjustment to the lease obligation.

The right-of-use asset would be presented in the property, plant, and equipment asset category on the taxpayer's balance sheet, but separately from assets that the taxpayer entity actually owns.

The right-of-use asset would be amortized on a systematic basis that reflects the pattern of consumption of the expected future economic benefits.

Lease payments would be allocated between interest expense and a reduction of the lease obligations using the effective interest method, rather than being recognized as rent expense under the straight-line method.

The accounting by a lessor would reflect the lessor's exposure to the risks or benefits of the underlying leased asset. A lessor that has transferred significant risks or benefits would recognize a gain or loss, measured at the lease commencement date. When the lessor retains significant risks or benefits in the leased asset, it would recognize income over the lease term.

Lessee taxpayers would be required to disclose the terms of contingent rent, renewal options, termination options, residual value guarantees, and purchase options of leases.

In addition, lessee taxpayers would be required to show a reconciliation of the opening and closing balance of the right-to-use asset and lease liability. And, lessee taxpayers would be required to show the future lease payments that they are expected to make over the next five years and thereafter. These payments would be distinguished between

1. contractual minimum lease payments and
2. payments related to variable lease payments and residual value guarantees.

It is important to note that the lease term definition to be applied under the proposed GAAP changes would include any options to extend or terminate the lease.

Under the proposed GAAP changes, the lease term is defined, for both lessees and lessors, as follows:

> The lease term is the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a significant economic incentive for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease.[4]

This lease term definition focuses on the longest possible lease term that is more likely than not to occur. This is a significant change from current lease accounting standards. The current lease accounting standards are focused more on the contractual minimum lease term.

Another significant difference between the current standards and the proposed standards is the estimate of lease payments. Under the proposed accounting standards, the lease payments estimate would include all future lease payments plus any variable lease payments (such as, contingent rent and renewal options), and residual value guarantees.

This is a change from the current accounting standards, which are focused on the contractual minimum future lease payments. Thus, a lease payment estimated under the proposed standards could be significantly different than a lease payment estimated under the current standards.

The result of the proposed GAAP changes to (1) the lease term definition and (2) the lease payments estimate is that the value of leased assets and liabilities reported on the lessee taxpayer's balance sheet could significantly increase.

This statement is true even for capital lease assets and liabilities that were already reported on the lessee taxpayer's balance sheet.

Timeline of the Proposed Changes

In March 2009, the Boards began the leases joint project with the publication of a discussion paper that (1) identified the main problems with the current GAAP lease accounting and (2) presented the Boards' initial thoughts on possible solutions to these problems.

Since March 2009, the Boards have undertaken extensive outreach activities (1) to keep interested parties informed of the progress of the leases project and (2) to seek feedback on the Boards' continuing deliberations.

In August 2010, the IASB and the FASB issued an exposure draft regarding the proposed changes to lease accounting. The IASB and the FASB decided to re-expose the revised proposals in the third quarter of 2011. Therefore, it is unlikely that any standard will be finalized until 2012, with an effective date of sometime in 2014.

However, taxpayer companies should begin to prepare for the proposed changes now. This is because a taxpayer company's 2012 and 2013 financial results and lease activities would need to be included in the 2014 financial statements.

Impact of the Proposed Changes on Taxpayer Capital Structure and Financial Ratios

The proposed changes could have a significant impact on a lessee taxpayer's capital structure. This is particularly true for lessee taxpayers with significant operating lease obligations.

According to a Credit Suisse analysis of the proposed changes,[5] the value of leases that would be reported on the balance sheets of S&P 500 companies as a result of the proposed changes could total approximately $550 billion. For some of these taxpayer companies, the value of operating leases exceed one-fourth of their market capitalization.

The reporting of these previously off-balance-sheet assets and liabilities would not only affect the balance sheet (lessee taxpayers may appear more leveraged than they did in the past). It would also affect the income statement, cash flow statement, and a wide variety of financial metrics and ratios.

Some of the lessee taxpayer metrics that may be affected include the following:

1. Total assets
2. Total liabilities
3. Return on assets
4. Operating margins
5. Leverage ratios
6. Interest coverage ratios
7. EBITDA/EBIT levels
8. Asset impairment
9. Capital structure
10. Cost of capital

The proposed changes would not impact a lessee taxpayer's total cash flow (i.e., the sum of cash flow from operations, cash flow from financing, and cash flow from investing). However, the proposed changes would change how lease payments are classified on the taxpayer's cash flow statement.

On the taxpayer's cash flow statement, the lessee would report all lease payments as cash flow from financing. That is a change from how lease payments are classified under the current standards. Under the current standards, capital lease payments are split between cash flow from operations (depreciation expense) and cash flow from financing (interest expense).

And, operating leases payments are reported in cash flow from operations. Even though the total cash flow would stay the same, the proposed changes would result in an increase in cash flow from operations and a decrease in cash flow from financing.

On the taxpayer's income statement, the lessee taxpayer would amortize the right-to-use asset over the life of the lease, and interest expense would be recognized on the lease liability.

The impact of the proposed changes on a lessee taxpayer will differ depending on the facts and circumstances of its current lease activity, including the length of the lease terms, variable lease payments, and residual value guarantees.

Impact on Property Tax Valuations

The proposed changes could have a significant impact on property tax valuations. This is because the proposed changes would bring off-balance-sheet obligations to the lessee taxpayer's balance sheet.

This change will affect all of a lessee taxpayer's financial statements and a wide variety of financial metrics and ratios. And, if the proposed changes were to change investors' view of the lessee taxpayer leverage and risk, then stock prices and financing costs may change as well.

The proposed changes could cause property tax analysts and other financial statement users to analyze and value taxpayer companies differently than they have in the past. This would be particularly true for airlines, railroads, and other capital-intensive companies that lease a lot of assets.

And, this is true even if property tax analysts were already making normalization adjustments for operating leases. This is because the proposed changes could provide a different view of the underlying economics of a lease by factoring in things like variable lease payments, renewal options, and residual value guarantees that may not have been captured in previous normalization adjustments.

The core principle of the proposed changes is that lease contracts give rise to assets and liabilities that should be reflected in the lessee taxpayer's balance sheet.

For valuation analysis purposes, long-term debt is usually defined to include all forms of interest-bearing long-term debt, including long-term lease obligations.

When performing a property tax valuation analysis, under the current lease accounting standards, analysts often adjust the amounts presented in financial statements to reflect the value of off-balance-sheet operating lease assets and liabilities.

This adjustment is particularly important when (1) performing relative valuations (such as, for example, the guideline publicly traded company valuation method) and (2) benchmarking (such as, for example, estimating a private taxpayer company's levered beta).

Under the current accounting standards, this adjustment may require the property tax valuation analyst to make assumptions regarding the specific characteristic of the operating leases (such as the lease term and payment structure). This is because the current standards do not require detailed information about operating leases to be presented in the lessee taxpayer's financial statements.

The objective of the proposed changes is to provide detailed information in the financial statements about the amounts, timing, and uncertainly of the cash flow that relates to lease contracts.

The result of the proposed changes would be that calculated financial ratios (leverage ratios, for example) would provide a more complete picture of a lessee taxpayer's assets and liabilities and make the financial statements of all lessees more comparable.

Property tax analysts, and other financial statements users, would no longer need to adjust the amounts presented in the taxpayer's balance sheet and the income statement to reflect the assets, liabilities, and finance costs of operating leases.

The implementation of the proposed changes may present some interesting problems for property tax valuation analysts. For example, any trend line/timeline analysis will make it appear that the taxpayer company (or the taxpayer industry) has changed materially after the implementation of the proposed changes.

However, this is just comparing new GAAP financial statements to old GAAP financial statements.

During the new standard implementation period, the valuation analyst may need to perform the following activities as part of a property tax valuation analysis:

1. Adjust the historical financial statements (prior to the new standards) to include the assets and liabilities of operating leases

2. Analyze the impact of an increased asset base due to the creation of the right-to-use asset
3. Analyze the change in income and expense recognition resulting from new lease obligations
4. Analyze the effect of new lease obligations on debt and equity ratios

The impact of the proposed changes on property tax valuations will be particularly important, especially for airlines, railroads, and other capital-intensive companies that lease a lot of assets. This is because these lessee taxpayers often structure their leases as operating leases.

And, as a result of the proposed changes, the value of these previously off-balance-sheet operating lease assets will now be reported on the taxpayer's balance sheet.

This new lease accounting treatment will eliminate the current property tax assessor argument that operating leases should be capitalized for property tax purposes (now, they will be).

However, the most important factor influencing the property tax assessment of leased assets remains: Who is contractually liable for paying the property tax expense on the leased property? The lessor or the lessee? Regardless of lease accounting GAAP, the only answer to this expense responsibility question can be found in the terms of the subject lease contract.

Summary and Conclusion

The IASB and the FASB have proposed significant changes to the current lease accounting GAAP. The proposed changes will require lessee taxpayers to report all lease obligations, including operating lease obligations, on the balance sheet.

The proposed GAAP changes are designed (1) to simplify lease accounting standards and (2) to improve the quality and comparability of financial information.

These changes are intended to present information in the financial statements about the amounts, timing, and uncertainty of the cash flow related to lease contracts.

The proposed GAAP changes may affect all lessee financial statements—and all resulting lessee taxpayer property tax valuations. Because the proposed changes (1) differ significantly from the current lease accounting GAAP and (2) affect all lessee financial statements, it is important that property tax valuation analysts, and other financial statement users, understand the proposed GAAP changes.

Taxpayer companies with substantial leasing activity should be prepared to (1) assess how the proposed changes will affect their financial statements and operations and (2) analyze the impact of the proposed changes on significant future lease transactions.

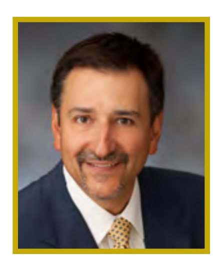
With respect to leased property ad valorem tax assessments, the central question remains: which party is contractually liable to pay the property tax on the subject leased property? The lessee or the lessor? This property tax obligation question can only be effectively answered based on a review of the terms and conditions of the subject property lease agreement.

The proposed GAAP changes may expedite the fair value valuation of leased assets (i.e., that amount will be reported on the lessee taxpayer's balance sheet).

However, that information is only useful after the factual determination of which party (lessor or lessee) is contractually responsible for paying the property tax expense related to the particular leased property.

Notes:

1. Shannon P. Pratt, Reilly F. Reilly, and Robert P. Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 4th ed. (New York: McGraw-Hill, 2000): 520.
2. "Dancing with Leases—GAAP Tangos Forward," Panel Discussion at The 41st Annual Wichita Program, August 2, 2011.
3. A few lease transactions would not be affected by the proposed changes including: (a) short-term lease contracts (defined as leases that have a maximum possible term of 12 months or less), (b) leases of biological assets (such as timber), (c) leases of intangible assets (for example: software, patents, and licenses), and (d) leases to explore for—or use—minerals, oil, natural gas and similar nonregenerative resources.
4. "Leases—Joint Project of the FASB and the IASB," last updated on September 23, 2011.
5. David Zion and Amit Varshney, "Leases Landing on Balance Sheet," Credit Suisse, August 17, 2010.



John Ramirez is a senior associate in our Portland, Oregon, office. John can be reached at (503) 243-7506 or at jcramirez@willamette.com.