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LEVERAGED LEASING

LEVERAGED LEASING REACHES CROSSROADS

Eliminating leveraged lease accounting rules would be contrary to historical precedent and bad for the U.S. economy..

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Most participants in the leasing industry agree that leveraged lease accounting uniquely captures the economics of the leveraged lease structure. That is, the amount shown on the balance sheet is the lessor's net investment, which represents the amount at risk of loss and the lessor's remaining economic resource in the lease. When a large component of the earnings comes from tax benefits, the earnings pattern appropriately mirrors the pattern of the lessor's “at risk” investment, net of the nonrecourse debt and deferred taxes used to fund a significant portion of the financing, and most accurately reflects the manner in which the typical lessor analyzes the economics of the investment. Lessees enjoy a lower all-in cost through the lease since lessors price the rents assuming their return is measured versus the net cash invested. The regulators of many financial lessors (in both the banking and insurance sectors) also recognize that the capital requirements need be maintained against only the net investment in the lease. All of this makes perfect sense to practicing leasing participants except that the tentative decisions in the Financial Accounting Standards Board (FASB)/International Accounting Standards Board (IASB) lease accounting rules project (the Leases Project) proposes to eliminate this fair and consistently applied accounting rule.

History and the good of the U.S. economy are reasons alone to keep the leveraged lease accounting rules in place. The first leveraged leases were completed in the late 1960s for the shipping, printing, and railroad industries. The practice developed and expanded after the advent of accelerated depreciation and investment tax credits (ITC). These capital intensive industries were soon followed by others, including airlines, utilities, and general manufacturers, which were also not able to use the tax benefits from owning equipment efficiently but could share in some of the value through lower rental payments. The sources of capital to lend to these industries were (depending on the era) generally broad and sourced from a diverse group of institutional investors under private or public placements. The equity interest (i.e., lessor) came from investors, who had tax capacity as well as knowledge of the residual interest in the underlying equipment. The result was the practice of bifurcating the capital sources for larger transactions and the reference to “non-recourse debt,” which means the debt is not an obligation of the lessor but instead derives its credit support through an assignment of the lease and security interest in the underlying assets. The FASB issued Statement No. 13, Accounting for Leases, in 1976, and while there has been ongoing debate concerning the transparency of lessee accounting, U.S. practitioners have generally not had issues with leveraged lease accounting for lessors.

LEVERAGED LEASES

According to the FASB's ASC Topic 840-10-25-42, a leveraged lease is a direct finance lease that includes the following characteristics:

- At least three parties are involved: a lessee, a long-term creditor, and a lessor (commonly called the equity participant).
- The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitted rentals relating to it). The amount of the financing is sufficient to provide the lessor with substantial "leverage" in the transaction.
- The lessor's net investment, as defined to include the deferred tax balance, declines during the early years once the investment has been completed and rises during the later years of the lease before its final limination. Such decreases and increases in the net investment balance may occur more than once.

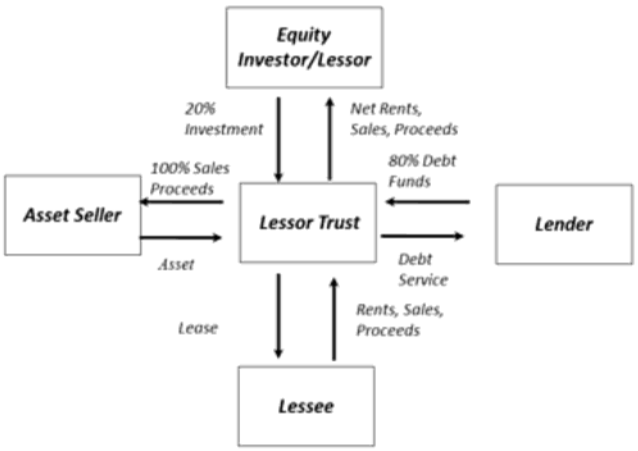
Further, according to ASC 840-30-35-33, revenue, including any investment tax credit, is recognized in a leveraged lease at a constant rate of return versus the net investment (including the deferred tax balance) over the lease term in periods during which the net investment is positive. The earnings rate is called the multiple investment sinking fund (MISF) yield. The net investment declines and rises due to the combination of the rent and residual cash flows, the tax cash flows, which include temporary differences, and the recognition of revenue.

In practice, the typical leveraged lease involves a lessor trust that sources funds of approximately 80% from the equity participant/lessor and 80% from the long term non-recourse lender (an institutional investor like an insurance company), which are used to purchase the leased asset that that is leased to the lessee. The lessor trust gives the lender a mortgage on the asset and a non-recourse assignment of the lease and lease payments. The lessee then makes periodic payments to the trust that are used to pay the lender with any

excess rents and residual sale proceeds paid to the equity participant. As owner of the asset, the lessor is entitled to investment tax credits, if any, and tax deductions for depreciation (MACRS deductions) on the asset and interest on the non-recourse debt. See Exhibit 1.

Exhibit 1. Leveraged lease structure

Exhibit 1



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Investment tax credits and the Section 1603 grant program: acatalyst for retaining leveraged leasing

The availability of ITC had been spotty from the late 1980s until the Energy Policy Act of 2005. The sanctioning by Congress of ITC and production tax credits for renewable energy projects has developed new and existing structuring techniques to monetize such tax benefits. Prior to the economic crisis of 2008, it was relatively easy to assemble project finance packages for large scale renewable energy projects. Companies with large tax liabilities could monetize the tax incentives and became ideal off-takers for the tax benefits that were being created in these projects. In particular, large wind and solar farms flourished due to the large appetite for tax equity investments. However, one of the many consequences of the recession was the dramatically reduced number of tax equity players willing to participate in these renewable energy projects.

To remedy this problem, Congress included a provision in the American Recovery and Reinvestment Act of 2009[1] (ARRA) package passed in 2009 to allow for a cash grant in lieu of the tax credit offered for renewable energy projects. Commonly referred to as the Treasury 1603 grant, this program provided a 30% cash grant instead of the 30% ITC previously offered to renewable energy developers. This was important, as many investors did not have sufficient taxable income to use tax credits while the grant was paid regardless as to whether the tax owner had a tax liability. The introduction of “bonus” tax depreciation in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[2] was an incentive provided to all industries to help with the recovery, currently allowing 50% of an asset's cost to be deducted in the computation of taxable income in the year placed in service.

Leveraged leasing has been used to finance several billion dollars of grant-eligible wind projects in the past 18 months. The trend for solar projects eligible for ITC since grants were introduced is for the projects to be financed on a lease basis because the structure affords an efficient sharing of the tax benefits as well as residual and operating risks between lessees and lessors. In addition to the renewable energy sector, utilities are candidates for leveraged leasing because they are faced with large capital expenditures to comply with new Environmental Protection Agency (EPA) rules for their carbon emissions. These industries are not able to efficiently use the ITC, bonus depreciation, and other tax benefits associated with their new investment programs.

For many larger projects, leveraged leasing would be a preferred financing structure were it not for the uncertainty surrounding the potential elimination of the accounting rules affecting the structure through the Leases Project. Such changes would also affect single-investor direct finance lease accounting because of the inability to record the ITC as a cash flow item in determining the pre-tax income profile (as detailed further below). Eliminating the accounting rules that would otherwise help to lower the financing cost for these industries is inconsistent with Congress' intent when it created the incentives. Additionally, the resulting higher financing costs are bad for American business.

Assuming investment grade equivalent credit quality of the lessee, a leveraged lease currently would offer substantial savings (upwards of 40 to 60 basis points (bps) per annum in implicit cost) to potential lessees when compared to the single investor structure. This can equate to 3% to 5% of equipment cost from a net

present value (NPV) savings perspective. Importantly, the benefits of leveraged leasing also include the ability to finance large transactions with a funding structure that has significant precedents over a long history of transactions arranged in the market. As a practical matter, for many large-ticket transactions ($100 million plus), lessees would find it difficult to source sufficient tax equity to complete a transaction using a single investor structure. Given the ability to leverage a transaction with capital markets debt, lessees can avail themselves of the economic benefits of leasing for even the largest of their financing requirements.

Recent developments: FASB and IASB Lease Project

Although the initial Leases Project Exposure Draft and the consensus coming from the meetings of the FASB and IASB (the Boards) up to this point have been bleak with respect to leveraged lease accounting, recent meetings have put the Leases Project into a possible impasse. This leaves hope for possible leveraged lease relief. The potential impasse surrounds the lease expense pattern for lessees. The FASB favors a method similar to current GAAP in which the expense would generally be the straight-line average rent paid over the lease term. The IASB favors a cost pattern that has the effect of front-ending the lease costs for the lessee in most leases. The two Boards seem unwilling to compromise. They will try to work out a compromise, but they did discuss the following possible outcomes and impacts on accounting regulators:

- The Boards retain current lease GAAP but expand disclosure of lessee operating lease obligations. This may also mean changing the U.S. lease classification tests to the IAS 17 lease classification methodology because the FASB thinks they have more substance than the FAS 13 classification tests. In this case, the FASB may have more control of the Leases Project.
- The Boards part ways and each issues an exposure draft with differences in the lessee cost methodology, with the FASB adopting IAS 17 classification methods. In this case, the FASB would be in total control of its version of the Project.
- The Boards compromise on a method that creates a straight-line cost pattern and continue with the Leases Project. In this case, the FASB will share control of the Project.
- The Boards compromise on a lessee cost pattern that front loads the lease cost and continue with the Leases Project. In this case, the FASB will share control of the Project.

The possible outcomes may favor retaining leveraged lease accounting in the U.S. or at least grandfathering existing leases as the Boards may choose to part ways or retain current GAAP. This may allow the FASB to act to keep the existing leveraged leasing rules in place without having to contend with the IASB. At least two of the FASB board members appear to favor some relief for leveraged leases.[3] Additionally, FASB members usually are willing to listen and react to sound arguments.

Leveraged leasing is strictly a U.S. issue. IAS 17 does not include this method because there is not an active leveraged leasing business in other international locations with the exception of Japan. (Japanese GAAP follows U.S. precedent in this case.) The lease accounting project is a joint undertaking by both Boards, and when the discussions surfaced on leveraged leasing in the deliberations, the IASB showed no interest in the topic. As such, the FASB was resigned to dropping it from the proposed rules. A decision determined on the basis of the international community's differing tax regimes and less mature capital markets, and the absence of this financing practice, makes no sense and is totally unfair to the U.S. financial markets. Eliminating

accounting for a structure that could become more widespread as international corporate finance matures appears to be a step backwards.

Market precedent for financing infrastructure outside of the U.S. has always been more driven by the bank lenders than the capital markets. The best example is the role municipal financing plays in the U.S., while similar tax-advantaged financing is virtually non-existent in other regions. While there is a global leasing business, few other countries have maintained consistent tax rules that would provide for the long-term use of tax-oriented leasing. Furthermore, the preferred approach for incentives in the renewable energy sector has been through feed-in-tariffs rather than tax benefits.

The Boards also have decided not to grandfather existing leveraged leases even though they have allowed grandfathering of existing direct finance and sales-type leases. It appears that the Boards grandfathered those lease types to make transition simpler for the lessor. That same process should apply to leveraged leases, which are much more complex to transition to the proposed rules. All of this may be due to the fact that the IASB does not consider leveraged leases to be an issue, which means the FASB must initiate any relief. Beyond the historic and “good for business” rationales, the technical accounting and practical arguments for preserving leveraged leases are:

- The current accounting methods for leveraged leases best reflect the true and substantive economic effects of a leveraged lease and provide the most useful and transparent information to users of lessor financial statements. The netting is justified by the three-party leveraged lease agreement in which the lessee agrees to pay rent to the lender. The reported lessor's net investment is the only remaining economic resource in the lease that it controls. The revenue recognition method recognizes tax benefits as a revenue item, and therefore the earnings pattern considers tax impacts and matches the interest expense pattern.
- Eliminating the accounting standards would wreak havoc on existing investors' portfolios due to the need to re-book existing transactions, which were executed in good faith assuming that the rules would not change. Leveraged lessors are trying to sell or restructure leveraged leases to avoid the negative results of retroactive elimination. All options available result in loss of some economic benefits.
- Leveraged leases are becoming less common. This is due somewhat to the expectation that the rules will change. Additionally, since 2006 when the project was announced, the market has resulted in more complicated lease structures using partnerships and other approaches to leverage these lease transactions efficiently. Accounting treatment does matter, and the real losers have been lessees, who have experienced higher financing costs.
- Most leveraged lease lessors are regulated financial institutions. The retroactive elimination of leveraged leases will create capital needs because the assets will be grossed up and earnings will be reversed. U.S. financial institutions will still need more capital to return to safe levels.
- The transition rule to rebook the lease on a gross basis and adjust revenue taken to date is very complex and burdensome.
- At this time, when significant capital formation for renewable energy projects targeted by the U.S. government is severely lacking, leveraged leasing can continue to provide a source of capital. This is especially the case for projects eligible for ITC. A leveraged lease is typically less complex and has

greater market precedents than some of the alternative financing structures used in the renewable energy sector, such as the partnership "flip" structure. The White House recently hosted a meeting of renewable energy industry structuring sources and potential tax equity investors, seeking to encourage investment in renewable energy projects and the partnership "flip" structure in particular.[4] Few corporate investors jumped at the opportunity, whereas many more investors, including some at the meeting, have long histories of investments in leveraged leases.

Applying the proposed rules to an alternate energy asset lease shows the shortcomings of eliminating the existing rules. Absent leveraged lease accounting, the lease would be recorded as a single investor lease (direct finance lease). The ITC would be accounted for under tax accounting rules, namely ASC Topic 740 formerly known as FAS 109. ASC Topic 740 requires the lessor to either take all the ITC as a credit to tax expense in the year received or to amortize it straight-line over the lease as a credit to tax expense. The ITC is not classified as revenue, whereas it is so classified in current practice for direct finance leases. The lease revenue (rent plus residual less asset cost) will be recognized at a constant yield in relation to the pretax investment, not the net investment including tax cash flows. The book/tax timing differences that create tax deferral will be ignored for revenue recognition—the benefits will be only indirectly reflected in the P&L in the form of lower interest costs to carry the investment. With the current tax benefits of 30% ITC and 50% bonus MACRS (modified accelerated cost recovery tax depreciation), the pre-tax yields in most leases of renewable energy assets are minimal if not negative.

The real answer is to provide meaningful information in lessor financial statements by the FASB, continuing with current practice, in which the ITC is considered a cash flow in the yield calculation and is amortized as tax free revenue—not a reduction in tax expense. If leveraged leasing is eliminated, the Boards at least should provide for current U.S. GAAP revenue recognition, which includes the ITC as part of lease revenue. The ITC amortization is a significant component of the economic substance of these transactions; by flowing the transaction through the tax provision line; the book income recognition of the transaction itself is somewhat lost in the details of a financial statement. Indeed, accounting treatment does affect the cost quoted to the customer and the willingness of the lessor to offer the product, considering its effects on reported results. In the author's experience, lessors have passed on leases with good yields when the earnings were not shown in revenue but rather as tax savings. Lessors have also charged higher rates if the earnings pattern was not at a constant rate versus the asset balance as reported to shareholders. The current GAAP pattern of revenue recognition is a good reflection of the economics in the lessor's pricing of the lease, including the impact of tax credits. Exhibit 2 illustrates the difference between current U.S. GAAP and the two proposed GAAP rules for both pre- and after-tax earnings (as a percent of equipment cost) and pre- and after-tax return on assets (as a percent of the book lease asset balance).

Exhibit 2. Pre-tax and after-tax earnings and return on investment

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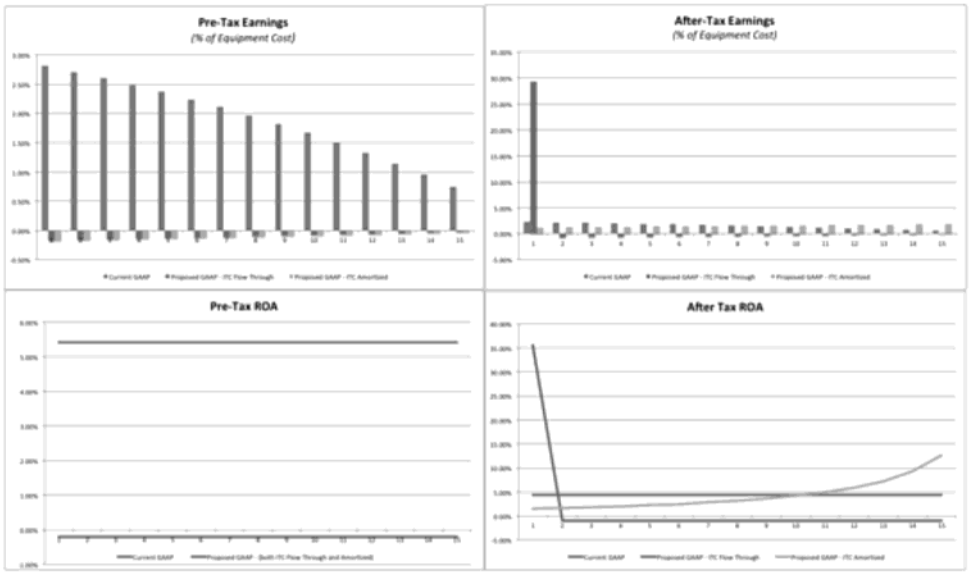

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Some have argued against the netting of non-recourse debt with the rent receivable in leveraged leases, because in cases other than leveraged leases, the netting of non-recourse debt is not allowed. This common branding of leveraged leases with other investments ignores the favorable historic and economic impact for

both U.S. lessors and lessees. The FASB should reconsider netting of non-recourse debt for *all* leases funded with non-recourse debt.

A case in point is how many independent lessors fund their leases. They execute non-recourse loans with banks, discounting the rents in the lease at the lender's rate and allowing the lender to have a lien on the underlying asset as well. This is economically the same as a leveraged lease, but it does not match the form of a leveraged lease (it is not done at inception via a three-party agreement). The rents in a lease funded after -the-fact with a non-recourse loan are, in substance, the same as the rents in a leveraged lease because the rents are no longer an economic resource of the lessor. The lessor cannot sell the rents, and it has already received the economic benefits in the rents when the lender funded its lease with non-recourse debt.

What is the best, most useful information regarding the rent receivable financed by non-recourse debt for a prospective lender or investor? It seems misleading to show the rents as an asset since the prospective lender will get no benefit from that asset in a bankruptcy and a prospective investor cannot get any economic benefit by selling or collecting on the asset as it would violate the debt agreement. The rents go to pay off the loan. The purpose of netting is to show that the non-recourse debt arrangement causes the rent to fail to meet the current GAAP definition of an asset. That definition is: “An *asset* of an entity is a present economic resource to which the entity has either a right or other access that others do not have.” The lessor can derive no further economic benefit from the rent as it is no longer a present resource. The lender has the rights to the asset that the lessor no longer has. Also, if one looks at the grand scheme of U.S. financial statements, the asset appears on two sets of books if it is not netted by the lessor. It appears on the books of the lessor as a lease receivable and the books of the non-recourse lender as a loan receivable.

Conclusion

Leveraged lease accounting should be retained, tax benefits should be included in the lessor revenue recognition methods in the Leases Project, and netting of non-recourse debt should be considered for all leases funded with non-recourse debt. These recommendations improve the transparency of lessor financial statements and allow lessors to charge lower rates to lessees. All of this would be good for U.S. businesses at a time when the nation's banking system, economy, and energy policy need help. A move away from convergence in the Leases Project may enable the FASB to take up these recommendations.

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[1]

P.L. 111-5, 2/17/09.

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[2]

P.L. 111-312, 12/17/10.

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[3]

WG&L Accounting & Compliance Alert on Checkpoint, 7/8/11.

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[4]

"Renewable Firms Seek Tax-Equity Partners,"*Wall Street J.*, 2/11/12, p. B3.

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