Good News – ITC Confirmed as Lease Revenue

The new rules get it right

By: Bill Bosco, Leasing 101

Hooray, the new leasing rules, Topic 842, allow ITC (investment tax credit) to be amortized as revenue in a direct finance lease, but you have to weave your way through the words, connect some dots and interpret a bit to figure out how to do it, which I do in this article. I also assume that a tax grant in lieu of the ITC would be accounted for using the same methodology. Reporting ITC as a "grossed up" revenue item versus a credit to tax expense is a key issue for large financial institutions because equity analysts and investors look at net revenue from funds and operating efficiency ratios to compare financial performance. If the ITC is credited to tax expense it distorts returns on earning assets and sort of gets lost in the revenue analysis. As a side note, I have made some money over the years helping a few large ticket lessors justify amortizing ITC in alternate energy leases with their auditors. I guess I have to revise my revenue forecast as there should be no question going forward.

First, I say thanks again to the FASB board and staff for listening regarding formally stating that ITC is a component of lease revenue. There were only three comment letters that I recall that asked them to clarify ITC accounting for non-leveraged leases. The letters were my letter, the ELFA's letter and a letter written by a coalition of large ticket lessors supported by the ELFA but led by Ted Jenkins, now with PNC. The FASB staff read the letters and asked me for some background and explanations. I provided them with information but I did not know how they came down on the issue until I read the final rules.

Let's look at the history of the issue. FAS 13 (Topic 840) explained how to account for ITC in a leveraged tax lease, that is, to treat it as a cash flow in the lease and to use the MISF yield (the after tax yield) to amortize it as a component of lease revenue. Topic 840 was silent as to ITC accounting for non-leveraged tax leases. Lessors used leveraged lease accounting by analogy but used the pretax implicit rate in the lease to amortize the ITC as a component of revenue. That practice was endorsed by the Big 4 and included in their lease interpretations guides. ITC was suspended in 1986 for all asset types so the industry and accounting profession kind of lost their intuitional memory of the interpretations. With the reinstatement of ITC for alternate energy assets in 2006, ITC accounting became an issue again, but it impacted a limited number of leases so it was not a pervasive issue. The credit is 10-30% depending on the type of alternative energy asset with 30% being the most common as it applies to wind and solar assets. The Big 4 were not consistent in allowing amortization of the ITC as revenue so it often became an issue to be defended and supported with evidence of practice from the 1980's.

The New ITC Accounting Rules

Guidance for ITC accounting is sparse in the new rules. Here is how I weave through the new rules to find the roadmap to ITC accounting in a direct finance lease. The definition of the rate implicit in the lease includes "any related investment tax credit retained and expected to be realized by the lessor". The rules do not include an example to show of the initial entry to record a direct finance lease with ITC or the subsequent accounting. The rules state at the commencement date of a direct finance lease, a

lessor shall recognize the net investment in the lease and derecognize the underlying asset. The net investment is defined as the discounted value of the receivable and unguaranteed residual. For a lessor, the discount rate for the lease is defined as the rate implicit in the lease. A lessor shall determine the interest income on the net investment in the direct finance lease in each period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. I conclude that the ITC must be part of the revenue in the direct finance lease for the math to work where the implicit rate in the lease (where ITC is an element) is applied to the net investment in the lease (that net investment reflects the netting of ITC as the implicit rate in the lease is used to discount the receivables and residual).

I read this to say a lessor will record a rent receivable, residual, ITC receivable as assets and record a cash disbursement to buy the asset with the difference credited to unearned income. ITC is a tax credit so it results in a permanent book vs. tax difference. The IRS tax rules also require that the lessor reduce its depreciable basis in the asset by half of the ITC amount, creating another permanent book vs. tax difference. It gets more complicated when you consider the book vs tax timing differences created by the differences in accounting for direct finance leases that are true leases, as for tax purposes you have to use operating lease accounting.

ASC 740 (Accounting for Income Taxes) covers the accounting for the book tax differences and uses complex simultaneous equations illustrated below. To account for the book tax differences a deferred tax asset is recorded at lease commencement. The deferred tax asset is difference between the book basis and the tax basis of the asset grossed to a pretax equivalent using the lessor's income tax rate. The grossing up of the basis is necessary to result in a normal relationship between the tax provision and pre-tax accounting income. This presents the ITC revenue on a grossed up basis which is how a lessor considers ITC in pricing a lease.

An Example

Since this is so complex an example is needed. I have Rod Hurd, Deborah Brady and Joe Sebik of the ELFA accounting committee to thank for helping with this example and article. The example does not include state tax effects. The lease in the example is a direct finance lease as the PV of the rents, in advance, using the 4.09% implicit rate in the lease is 93% of the book basis (the ITC expected to be realized is a subtraction to arrive at the value of the equipment for purposes of the "substantially all" present value of lease payments lease classification test) as calculated under the Topic 740 methodology. In many alternate energy leases with tax credits/grants there may be a need to buy residual insurance to achieve direct finance lease classification.

ACCOUNTING FOR RENEWABLE ENERGY LEASES			
ASSUMPTIONS			
Pricing Parameters		**After-Tax Income**	
Cost	$ 100,000	Cost of equipment	(100,000)
ITC % of Cost	30%	ITC	30,000
ITC Amount	30,000	Rents	84,000
ITC Basis Reduction	50%	Residual	10,000
Monthly Rents (% of cost)	0.35%	Income Taxes	(3,150)
Monthly Rent Amount (in advance)	350	Net after-tax cash	20,850
Residual %	20%		
Residual Amount	10,000	Pre-tax income (loss)	(6,000)
Lease term (years)	20	Cash on Cash Return	6.00%
Initial Book Basis		**Initial Tax Basis**	
Book Basis (per EITF 98-11/Topic 740)	61,923	Cost	100,000
Deferred tax asset	8,077	Basis reduction	(15,000)
Book basis + DTA	70,000	Depreciable Tax Basis	85,000
Cost	100,000	**PV classification test**	
Less: ITC	(30,000)	Implicit rate in the lease	4.09%
Net Cost	70,000	PV of rents (in advance)	57,504
		Book basis	61,923
Depreciable Tax Basis	85,000	PV vs. Book basis	93%
Tax rate - book	35%		
Tax benefit - depreciation	29,750		
Cost	100,000		
Less: ITC	(30,000)		
Less: tax benefit-depreciation	(29,750)		
Cost-ITC-tax benefit	40,250		
Gross up at 1-tax rate	65%	Tax Rate - current tax	35%
Book Basis	61,923		

The asset's cost is $100,000. The ITC available is 30% of asset cost. Therefore, in effect, the cash price paid by the lessor is $70,000 ($100,000 cost – $30,000 ITC). The tax basis (the IRS rules require a basis reduction of half the credit) of the asset is $85,000 ($100,000 – ((30% * $100,000) * 50%)). The lessor's tax rate is 35%.

TOPIC 842/TOPIC 740
ITC REPORTING ON REVENUE LINE
ANNUAL DETAILS

PERIODS/YEARS	Initial	1	2	3	4 to 17	18	19	20	
CASH	-100000	-49420	-41930	-36344	……	8,891	11,621	20,850	
					……				
ITC Receivable	30000				……				
					……				
RECEIVABLE	84000	79800	75600	71400	……	8,400	4,200	-	
RESIDUAL	10000	10000	10000	10000	……	10000	10,000	-	
UNEARNED	-32077	-29592	-27176	-24836	……	-1104	-474	-	
	61923	60208	58424	56564	……	17296	13,726	-	
					……				
DEF TAX ASSET	8077				……				
					……				
TOTAL		10788	16494	20220	……	26,187	25,347	20,850	
					……	-	-	-	
DEF TAX LIABILITY		9173	13308	15513	……	6,054	4,804	-	
					……	-	-	-	
RETAINED EARNINGS		846	1669	2467	……	20,133	20,543	20,850	
					……	-	-	-	
TOTAL LIAB + EQUITY		10788	16494	20220	……	26,187	25,347	20,850	
					……	-	-	-	
ROA		0	0	0	……	0	0	-	
					……	-	-	-	CHECK
INCOME STATEMENT					……	-	-	-	TOTALS
Lease Income		2485	2416	2340	……	772	630	474	32,077
					……	-	-	-	-
Provision for Taxes					……	-	-	-	-
Current		-16380	-3290	-1386	……	1,470	1,470	4,971	3,150
Deferred		17250	4135	2205	……	-1199	-1250	-4804	8,077
		870	845	819	……	271	220	167	11,227
					……	-	-	-	-
NET INCOME		1615	1571	1521	……	501	410	307	20,850
					……	-	-	-	-
TAX PROV/LEASE INCOME		35%	35%	35%	……	0	0	0	-
					……	-	-	-	-
CASH FLOWS					……	-	-	-	-
OPERATING					……	-	-	-	-
Rent		4200	4200	4200	……	4,200	4,200	4,200	84,000
Taxes paid (received)		46380	3290	1386	……	-1470	-1470	-4971	26,850
		50580	7490	5586	……	2,730	2,730	(771)	110850
INVESTING					……	-	-	-	-
Cost of equipment		-100000			……	-	-	-	-100000
Sale of residual					……	-	-	10,000	10000
		-100000	0	0	……	-	-	10,000	-90000
					……	-	-	-	0
NET CASH PER YEAR		-49420	7490	5586	……	2,730	2,730	9,229	20850
									-

The first equation is to determine the final book basis of the equipment:

Final Book Basis – (Tax Rate * (Final Book Basis – Tax Basis)) = Cash Price Paid

Substituting from above and solving for the final book basis “X,” the equation becomes

X – (35% * (X – 85,000)) = $70,000

X = $61,923

The second equation is used to determine the amount of the deferred tax asset:

(Tax Basis –Final Book Basis) * Tax Rate = Deferred Tax Asset

Substituting from above and solving for the deferred tax asset "y," the equation becomes

($85,000 – $61,923) * 35% = Y

Y = $8,077

The initial journal entry to purchase the asset and record the effects of the ITC is:

dr. Equipment	$61,923	
dr. Deferred Tax Asset	8,077	
dr. ITC Receivable	30,000	
cr. Cash		$100,000

The entry to record the lease as a direct finance lease is:

dr. Lease Receivable	$84,000	
dr. Residual	10,000	
cr. Unearned Income		$32,077
cr. Equipment		61,923

The entries for the first year's activities are:

Rent collected:

dr. Cash	$4,200	
cr. Lease Receivable		$4,200

Revenue recognized using the implicit rate (4.09%) applied to the investment on a monthly basis, summed to the annual amount:

dr. Unearned Income	$2,485	
cr. Lease Income		$2,485

Receipt of ITC through claiming it in the annual tax return:

dr. Cash	$30,000	
cr. ITC Receivable		$30,000

To record the tax provision:

dr. Tax Expense	$870	
dr. Current Tax Liability	16,380	
cr. Deferred tax Liability		$17,250

The Federal tax rate = 35%

Book income	*$2,485 x 0.35 = $870*
Tax income: Rent	*$4,200*
Less MACRS (including bonus)	*51,000*
	$46,800 x 0.35 = $16,380

Conclusion

The good news is that the FASB listened and allows for ITC/tax grants to be accounted for as lease revenue under the new rules. The method illustrated above also grosses up the ITC portion of the lease revenue to its pretax equivalent. This helps portray the substance of ITC in a direct finance lease as a lease cash flow and lease revenue item – not a credit to tax expense. It helps users of financial statements to understand the "economic" revenue created by the leases. What is not so great is that the FASB did not include any examples or detailed guidance covering ITC accounting in the new standard. As a result we have to interpret. What is also not so great is the complexity in the accounting because of the permanent and temporary differences. Maybe the bright side of the not so great parts of the new rules is that you need to have smart accountants and systems people on staff and they need to get a raise to deal with the complexity.

About the Author:

Bill Bosco is the Principal of Leasing 101, a lease consulting company. Bill has over 40 years' experience in the leasing industry. His areas of expertise are accounting, tax, financial analysis, structuring, pricing and training. He has been on the EFLA accounting committee since 1988 and was chairman for 10 years. He is a frequent author and speaker on leasing topics. He has been selected to the FASB/IASB Lease Project working group. He can be reached at wbleasing101@aol.com, www.leasing-101.com or 914-522-3233.