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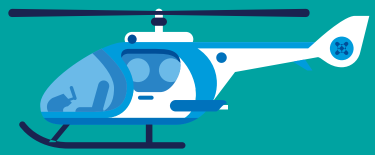

# Defining Issues®

## FASB approves changes to lessor accounting for sales and similar taxes and certain lessor costs

November 1, 2018

KPMG reports that the FASB approved a lessor practical expedient for taxes and changed how lessors will account for lessor costs paid by the lessee.

### Applicability

- **Sales and other similar taxes.** Lessors that enter into leases that give rise to sales and other similar taxes.
- **Lessor costs paid by the lessee to a third party.** Lessors in leases for which the lessee pays lessor costs directly to a third party.
- **Lessor costs paid by the lessee to the lessor.** Lessors in leases for which the lessee pays lessor costs as part of the fixed lease payments or reimburses the lessor for such costs.
- **Variable payments allocable to lease and non-lease components.** Lessors in leases that give rise to variable payments at least partially allocable to a non-lease component.

### Key facts and impacts

At its October 31 meeting the Board voted to issue an ASU that will amend ASC 842[1] to:

- add a lessor practical expedient substantially similar to the practical expedient for vendors in the revenue standard[2] that will permit lessors to present sales and other similar taxes that arise from a specific leasing transaction and related collections from the lessee on a net basis;
- require a lessor to present lessor costs paid by the lessee directly to a third party on a net basis regardless of whether the lessor knows, can determine or can reliably estimate those costs (i.e. not reflected on lessor's income statement);
- require a lessor to present all lessor costs paid by the lessee to the lessor on a gross basis; and
- clarify that lessors should recognize variable payments allocable to non-lease components as revenue under other US GAAP (e.g. ASC 606).

The amendments will be effective:

- for non-early adopters, when they adopt ASC 842;
- for early adopters, at whichever one of the following (applied prospectively or retrospectively) they elect:
  - beginning of the financial reporting period in which the ASU is issued;
  - beginning of the first financial reporting period after issuance of the ASU; or
  - the company's original mandatory effective date of ASC 842.

The amendments will apply to new leases and existing leases. Existing leases refer to all leases that commenced before the company's date of adoption of ASC 842.

[1] ASC 842, Leases

[2] ASC 606, Revenue from Contracts with Customers, and ASC 606-10-32-2A

## Sales and other similar taxes

The Board decided to affirm its proposal to create a practical expedient for lessors related to sales and other similar taxes.[3] This will allow a lessor, as an accounting policy election applied to all its leases, to present all funds collected from lessees for sales and other similar taxes net of the related sales tax expense. If elected, the lessor will present the taxes as if they are a *lessee cost* instead of assessing for each tax and/or taxing jurisdiction whether the tax is a 'lessor cost' or a 'lessee cost' based on who the primary obligor is.

A lessor that does not make this election will evaluate whether it is the primary obligor for in-scope taxes in each taxing jurisdiction (e.g. state, county or city) to determine whether the tax is a lessee or a lessor cost.

In response to feedback on the proposed ASU, the Board considered, but rejected, expanding the scope of the practical expedient to include property taxes.

### KPMG observation

**Taxes ineligible for the election**

The practical expedient applies only to those taxes that are in its scope. Ineligible taxes must be assessed by the lessor in each applicable taxing jurisdiction.

**Operational relief**

A lessor may operate in numerous taxing jurisdictions. Similarly, the lessor's customers (i.e. the lessees) may operate the lessor's underlying assets in numerous taxing jurisdictions. The primary obligor to the taxing authority for sales or other similar taxes can vary by jurisdiction. For example, the primary obligor for sales or use taxes in one US state may be the lessor, while in another it may be the lessee. This can add operational complexity to determining whether the lessee's payment of these taxes is payment of a lessor cost. Therefore, the practical expedient will likely eliminate some significant operational complexity for those lessors that elect it.

**Consistency in contracts with lease and non-lease components**

The Board's decision to enact the lessor sales and other similar taxes practical expedient appears to consider that, for contracts with lease and non-lease components, different guidance for in-scope taxes would create unnecessary complexity and not be logical.

Additionally, the Board appears to believe that enacting this lessor practical expedient is consistent with its broad view that leasing is fundamentally a revenue-generating activity for lessors.

## Lessor costs paid by the lessee directly to a third party

ASC 842 states that a lessee's payment of a lessor's costs (whether paid to the lessor or directly to a third party) is not a component of a lease contract. It currently requires a lessor to recognize lessee payments of lessor costs as additional lease and/or non-lease revenue, separate from the cost, regardless of whether the lessee makes the payments to the lessor or directly to a third party (e.g. taxing authority or insurance company).

Examples of lessor costs include taxes for which the lessor is the primary obligor or insurance covering the underlying asset for which the lessor is the primary beneficiary.[4]

It is not uncommon for the lessor not to know or expect to learn the amount of a lessor cost if the lessee pays the relevant third party directly. For example, a lessee may be required to obtain insurance on the underlying asset even though the lessor is the primary beneficiary of that policy. That insurance premium is, therefore, a lessor cost. However, the lessee may not be required to provide policy premium information to the lessor. Because the premium may be affected by numerous lessee-specific factors (e.g. credit rating, claims history or discounts for multiple policies), or because an umbrella insurance policy

[3] Proposed ASU, Leases, Narrow-Scope Improvements for Lessors

[4] See Section 4.2 of KPMG's Handbook, Leases

covers the underlying asset, the lessor may not know what the premium is. In that case, the lessor will not be able to present the lessee's payments and its associated costs on a gross basis without estimating the premium.

To respond to concerns about estimating lessee payments of lessor costs paid directly to a third party, the Board decided that lessors should be required to present such costs and the lessee's payments thereof on a net basis. Neither the lessor costs nor the lessee payments thereof will be reflected in the lessor's income statement, regardless of whether the lessor knows, can readily determine or can reliably estimate the cost paid by the lessee.

**KPMG observation**

**Significant change from proposed ASU**

The proposed ASU would have required net reporting of lessor costs paid directly to a third party only if the amount paid by the lessee was not 'readily determinable'.

Many stakeholders told the Board that it was unclear when certain lessor costs paid by the lessee to a third party would be considered readily determinable. For example, does readily determinable consider the effort the lessor might have to undertake to obtain relevant cost information?

The Board's decision simplifies the requirement from what was originally proposed because lessors will no longer have to consider whether the amount of an in-scope cost is readily determinable. However, it effectively abandons the link the Board previously drew between this requirement and the principal versus agent guidance in ASC 606 related to estimating gross revenue as a principal. Instead, the final requirement is purely an operational simplification.

**Different application to economically similar transactions**

The ASU will result in different accounting for a lessor based solely on the party to whom the lessee makes payment for the cost.

— A lessor remitting its own property tax payments and receiving reimbursement from the lessee will present its property tax cost and the lessee's reimbursement on a gross basis in the income statement.
— In contrast, an equivalent lessor that requires the lessee to pay the property tax bill directly to the taxing authority will present the cost and the lessee's direct payment on a net basis in the income statement. Based on the Board discussion it appears this will be the case even if the lessor provided the property tax bill to the lessee to pay.

As a consequence, lessors may be able to structure either a gross or net income statement outcome for items such as property taxes or insurance.

## Lessor costs paid by the lessee to the lessor

The ASU will not change lessors' accounting for lessor costs paid by the lessee to the lessor. Those costs and the lessee's related payments will continue to be presented gross in the lessor's income statement under ASC 842.

The ASU will include an amendment to ASC 842 explicitly stating that, for lessors, costs, such as property taxes and insurance, paid for by the lessee but for which the lessor remits payment to the relevant third party (e.g. taxing authority or insurance company) are lessor costs.

No analysis should be undertaken by a lessor to determine whether the cost is a lessor cost or a lessee cost.

**KPMG observation**

**ASU will apply only to lessors**

The forthcoming amendments apply only to lessors. The ASC 842 requirements that apply to lessees will be unchanged. Therefore, lessees will continue to assess whether costs such as those arising from property taxes, sales and other similar taxes and insurance are lessor costs or lessee costs.

## Variable payments allocable to lease and non-lease components

The ASU will amend ASC 842 to clarify that variable payments that are not part of the consideration in the contract:[5]

— should be allocated to the lease and non-lease components based on the transaction price allocation guidance in ASC 606; and

— the portion of such payments allocated to non-lease components should be recognized as revenue only when the requirements of the applicable Topic (e.g. ASC 606) are met.

A lessor should not automatically recognize the portion of a variable payment allocable to a non-lease component when the changes in facts and circumstances on which the variable payment is based occur, as it does for variable lease payments.

**KPMG observation**

**Changes from proposed ASU**

In response to feedback on the proposed ASU, the ASU will not specifically require allocating variable payments on the same basis as the initial allocation of the consideration in the contract or the most recent modification not accounted for as a separate contract.

Rather, a lessor will allocate a variable payment to only one or some of the components in the contract if the variable-payment specific allocation requirements in ASC 606 are met.[6]

## Disclosures

A lessor electing the sales and other similar taxes practical expedient will be required to disclose its accounting policy election and comply with the disclosure requirements in ASC 235.[7]

The Board did not mandate any specific disclosure requirements for lessors affected by the lessor costs amendments. However, lessors should consider the general lessor disclosure requirements in ASC 842, which may suggest disclosing information about the:

— nature of lessor costs paid by the lessee; and

— gross or net presentation of lessor costs and lessee payments thereof.

## Next steps

The FASB staff will draft the ASU for vote by written ballot, with the intent to issue the ASU by the end of 2018.

[5] ASC 842-10-15-40

[6] ASC 606-10-32-40

[7] ASC 235, Notes to Financial Statements

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**KPMG's Financial Reporting View**

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