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Written Submission of William G. Sutton, CAE
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before the U.S. House Committee on Ways & Means
Hearing on the Interaction of Tax and Financial Accounting on Tax Reform
February 21, 2012

Chairman Camp, Ranking Member Levin and distinguished members of the committee, I write to provide additional information to members of the House Committee on Ways & Means as a follow-up to your hearing on the interaction of tax and financial accounting on tax reform held February 8, 2012. This submission discusses how equipment financing is influenced by tax and accounting policies and highlights proposed changes being considered to lease accounting standards by the International Accounting Standards Board (IASB) and U.S. Financial Accounting Standards Board (FASB) that will impact the treatment of equipment leases.

Background on ELFA

The Equipment Leasing and Finance Association (ELFA) is the trade association that represents companies in the $628 billion commercial equipment leasing and finance sector, which includes financial services companies and manufacturers engaged in financing capital goods. This represents over half of the estimated $1.2 trillion U.S. annual expenditure for capital equipment acquisition. ELFA members are the driving force behind the growth in the commercial equipment finance market and contribute to capital formation in the U.S. and abroad. Its over 550 members include independent and captive leasing and finance companies, banks, financial services corporations, broker/packagers and investment banks, as well as manufacturers and service providers. ELFA has been equipping business for success for more than 50 years. For more information, please visit www.elfaonline.org.

ELFA members provide credit every business day to nearly every business and state and local government sector in the country. ELFA members finance the acquisition of all types of capital equipment, including commercial and corporate aircraft; rail cars and rolling stock; trucks and transportation equipment; vessels and containers; construction, agriculture and off road equipment; medical technology and equipment; IT hardware, software and capitalizable services; emergency communications; public transit; police and emergency vehicles; school buses; energy management and conservation equipment; and virtually every other type of equipment.

Business Use of Leases

Generally, leases are transactions involving equipment or other property acquired by a lessor and leased under an executory contract to the lessee. Leasing is such a pervasive activity in U.S. business that all companies lease equipment and real estate, some to greater extents than others, as a means to acquire the use of an asset without the burdens of ownership. Equipment financing can help mitigate the uncertainty of investing in a capital asset and may enable a business to achieve its desired return, increase efficiency, save costs and apply capital to more pressing needs of its operations. Our members offer flexible choices that can work with the diverse objectives of most businesses.

Leasing equipment provides advantages to both lessors and lessees. As owners, lessors have the ability to utilize significant tax credits, grants and accelerated depreciation deductions. Lessees can take interest payments as business tax deductions, create greater certainty in budgeting by setting customized rent payments to match cash flow, gain the ability to avoid equipment obsolesce, and provide services relating to installation, maintenance, de-installation and disposal of the equipment. The tax treatment under the Internal Revenue Code and the accounting treatment under current GAAP for lessees generally match, as rents are expenses for book purposes and rents are tax-deductible expenses for tax purposes. Only when there are uneven rents are there timing differences, but they are usually minor. The tax and accounting method treatment of leases make leases desirable for both lessors and lessees to utilize in their strategic business planning.

Proposed Changes to Lease Accounting Standards

A major convergence project currently under consideration by the IASB and FASB makes significant changes to GAAP for lessees by accelerating lease expenses for book accounting purposes. As proposed, leases would be capitalized resulting in an accounting asset and liability on balance sheets. Rent expense will be replaced by the straight line amortization or depreciation of the asset and imputed interest on the liability. This recasting of the lease transaction will produce a front ended expense pattern that will cause non cash book expenses generated by the executory lease contract to depress book earnings and equity capital. It will also cause a temporary difference for income taxes and create a significant deferred tax asset. The loss of capital from the front ended book expense pattern and the resulting deferred tax balance will in essence cause a permanent reduction in equity capital unless the lessee discontinues its leasing activities, which is virtually impossible for most companies.

This proposed change in GAAP would distort the financial presentation readers of financial statements will observe, giving the impression that the lessee is undercapitalized and has a deferred tax asset that may never be recovered in the future. A number of organizations and other stakeholders, including the ELFA, have recommended the proposal be revised so that the reported lease cost is equal to the average rent expense as under current GAAP so that the accounting reflects the economic effects of the lease. The most-effected industries are retail, transportation and banking--all key industries in the US economy. The loss of equity and the resulting deferred tax asset created by the proposed accounting will undoubtedly change lessee behavior (for example the first year cost under a 10 year lease will be 28% higher than under current GAAP) causing them to make uneconomic decisions. Investors will be confused by the new accounting and share prices may be impacted.

Additionally, the current proposed revenue recognition rules ignore tax benefits in lease investments, distorting the earnings pattern. Tax benefits are as much a part of revenue as cash from rents, yet taxes are ignored. The result of this is already evident, as no large leveraged leases have been closed since the project began as investors assumed the accounting treatment would be adverse. The lessees in long lived assets have suffered as alternative structures are more costly. Lessor behavior will change under the proposed rules avoiding lease structures with distorted revenue recognition and the result is increased lease costs for lessees. The current green energy tax credits and 50% bonus MACRS depreciation are tax benefits that serve to foster lease financing, yet the proposed rules will account for these in a way that makes for unattractive revenue patterns for lessors. We support maintaining leveraged lease accounting and revenue recognition so that fixed tax benefits in any investment are included in the earnings on the investment in a rational pattern versus the cash invested.

As the Committee is well aware, tax implications are critically important in commercial equipment acquisition for all sizes of companies. Thank you for the opportunity to provide this statement for the record on the value of leasing and equipment finance, and the additional information in regards to the interaction between tax and accounting standards. We look forward to expanding on the issues raised herein if members of the Committee or staff desire more information relating to these matters in particular, and the lease accounting project, generally.