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The Tax Import of the FASB/IASB Proposal on Lease Accounting

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THE TAX IMPORT OF THE FASB/IASB PROPOSAL ON LEASE ACCOUNTING

George Mundstock*

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I. INTRODUCTION

In August of 2010, the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly proposed new financial accounting rules for simple leases.1 Basically, the

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1 FIN. ACCOUNTING STANDARDS BD. (FASB), PROPOSED ACCOUNTING STANDARDS
proposal treats all leases as involving both the use of the leased property and the financing of that use. The proposal more accurately captures the economics of leases than do the current rules. As one would expect, those who prefer the current accounting rules have resisted the proposal and have delayed its implementation. This article reviews the proposal, considers how the proposed financial accounting rules would impact U.S. federal, state, and local tax-related matters, and then explores whether the proposal should be adopted as U.S. income tax law. The proposal would improve U.S. tax law by providing more accurate tax accounting for lease transactions and by laying the foundation for better rules for sourcing the leasing-related income of multinational businesses. Even if FASB and IASB do not implement their proposal, their approach provides the basis for valuable tax reform.

II. FINANCIAL ACCOUNTING FOR LEASES

Under a lease, the lessor and lessee share the benefits and burdens associated with the leased property. The lessee is entitled to use the


This article's analysis is based on George Mundstock, Taxation of Business Rent, 11 Va. Tax Rev. 683 (1992) [hereinafter Mundstock, Lease II]; and George Mundstock, The Mistaxation of Rent: Eliminating the Lease/Loan Distinction, 53 Tax Notes 353 (Oct. 21, 1991) [hereinafter Mundstock, Lease I]. Repeated citations thereto are omitted.


Obviously, leases can be very complicated. Services (e.g., maintenance of the leased property) can be provided under a lease, and leases can have variable rent, options to buy or extend, and other contingent features. In the interests of simplicity, this article does not reflect these complexities. The FASB/IASB proposal contains rules that take into account all
property for the lease term in exchange for becoming obligated to pay periodic rent. During the term of the lease, the lessee benefits from any increase in the value of the leasehold and is burdened by any decrease. For example, when the recent real estate bubble burst, rents declined considerably, and many lessee businesses felt the burden of long-term, high-rent leases entered into before 2007.

The economic benefits and burdens of a lessor mirror those of a lessee. The lessor exchanges the use of the leased property during the lease term for a promise of rent payments. As a result, the lessor is affected by a change in the value of the leased property only to the extent that the change impacts the residual value of the property at the end of the lease. The lessor also bears the risk that the lessee will not pay the required rent.

This analysis highlights a key feature of a lease. The lessee under a long-term lease incurs a significant debt: the obligation to pay rent for years. This obligation is not absolute. If the lessee defaults, this obligation may be mitigated if a substitute lessee is found. A bankrupt lessee's obligation may be reduced in bankruptcy. But, in most cases, the rent obligation must be satisfied. Under Generally Accepted Accounting Principles (GAAP), (i) the accounting for a transaction in the year that the transaction commences is based on the most likely outcome at that time and, (ii) if in later years things do not turn out as expected, the accounting is adjusted accordingly. Consequently, at least at the beginning of a lease, it makes the most sense to assume that all rent obligations will be fulfilled.

The primary motivation for the joint FASB/IASB project was to require lessees to show the obligation to pay rent on their financial statements. The boards put it as follows:

[The current rules fail] to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions. In particular, they omit relevant information about rights and obligations that meet the definitions of assets and liabilities in the boards' conceptual framework.

of these additional features in leases. FASB/IASB LEASE PROPOSAL, supra note 1, ¶¶ 6, 14–19, 33–41, 49–59, 83–86.

5 Mundstock, Lease II, supra note 2, at 696–97.

6 Id. at 703 n.55.

7 FASB's current view is that accounting statements should deal with uncertainties based on best estimates. FASB, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS No. 8, at ¶ QC16 (2010). Interestingly, this is different from the historic approach, which was called accounting "conservatism," that uncertainties should be resolved against showing profit and assets. Id. ¶¶ BC3.27–BC3.29.

8 FASB/IASB LEASE PROPOSAL, supra note 1, at 1.
Under current U.S. financial accounting rules, there are two types of leases: "operating leases" and "finance leases." Only finance leases are shown on a lessee's balance sheet. Basically, a lease is classified as a finance lease if either (i) the lease extends over seventy-five percent or more of the life of the property or (ii) the rent provided in the lease has a present value that is ninety percent or more of the value of the leased property. Under the current regime, very large, and potentially quite burdensome, long-term rent obligations do not appear on a lessee-business's balance sheet. Requiring this information would make financial statements more useful, which is their purpose.

The FASB/IASB proposal would apply one accounting regime to almost all leases of tangible property with terms longer than twelve months. At the beginning of a lease, the lessee's books would show a liability equal to the present value of the rent obligation and an asset of equal amount that represents the lessee’s “right of use” in the leased property. Each year, interest would accrue on the rent obligation, resulting in an expense and increasing the amount of the obligation. Rent payments would reduce the obligation. The right-of-use asset would be amortized, usually using a straight-line method, and further reduced if its value is impaired. This accounting regime shows an amount for the rent obligation and, through the impairment testing of the right-of-use asset, also informs financial statement users if the reporting business is burdened by an unfavorable lease.

Under the FASB/IASB proposal, similar rules would apply to a lessor. At the commencement of the lease, the lessor would book an asset equal to the present value of the right to receive rent in the future. An offsetting liability (deferred revenue) would represent the obligation to provide use of

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9 FASB, ACCOUNTING STANDARDS CODIFICATION § 840-10-20 (2012) (definition of "operating lease").
10 Id. § 840-10-25-1.
11 FASB/IASB LEASE PROPOSAL, supra note 1, at 1.
12 Id.
13 Id. at 3.
15 FASB/IASB LEASE PROPOSAL, supra note 1, ¶¶ 10, 12.
16 Id. ¶¶ 11, 16(a).
17 Id. ¶¶ 11, 16(b), 20, 24.
the asset to the lessee. Interest income on the right-to-receive-rent asset would be booked yearly. Rent received would reduce the right-of-use asset. The deferred revenue that is represented by the right-of-use liability would be amortized into revenue over the lease term, usually on a straight-line basis. The leased asset would be depreciated unless it is land.

The FASB/IASB proposal can be illustrated by the following example. A commercial leasing company purchases a new machine for $100. The machine is fairly standard and involves technology that is not changing rapidly, so that there is a good market in similar, used machines. Based on this market, the company can accurately anticipate the economics of owning the machine. The machine will last exactly five years, after which period, the machine will be worthless. In each of the five years, the machine will lose $20 of value (in the used equipment market). In other words, the economic depreciation of the machine will be straight-line with no salvage value. There is no risk. The annual market rate of interest on all investments is ten percent.

First, assume that the company leases the machine for three years in exchange for annual rent of $28.13 payable at year-end. The economic analysis underlying the $28.13 amount of annual rent is explained below. It is easiest to look at the accounting before examining the complexities involved in the pricing of the rent. Under the current financial accounting rules, the lease would create no liability and no new asset for the lessor or lessee. The lessee would have $28.13 in annual rent expense. The lessor would have $28.13 of rent income each year and would depreciate the machine.

The FASB/IASB proposal would provide very different accounting. At lease commencement, the lessee would book a liability of $69.95, the present value of the rent, and a right-of-use asset of $69.95. The liability then would be adjusted as follows:

---

18 Id. ¶¶ 30, 31, 37. Under the FASB/IASB proposal, in the rare case that the lessor does not retain “significant risks or benefits” with respect to the leased property, the lessor would treat the transaction as an installment sale of a term interest in the property, so that any unrecognized profit or loss in the leased property would be recognized at lease commencement. Id. ¶¶ 28, 29, 46–48. This possibility is not discussed in the text.

19 Yearly rent is used in the example for simplicity. End-of-year rent is discussed in the text because it is easier to see the interest component of rent when the rent is not prepaid. The Appendix redoes the text’s calculations with beginning-of-year rent, which reinforces the discussion in the text.

20 See infra text accompanying notes 23–25.

21 Obviously, there is rounding error in the calculations in this article.
<table>
<thead>
<tr>
<th>Year</th>
<th>Interest</th>
<th>Payment</th>
<th>Closing Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$6.99</td>
<td>$28.13</td>
<td>$48.81</td>
</tr>
<tr>
<td>2</td>
<td>$4.89</td>
<td>$28.13</td>
<td>$25.57</td>
</tr>
<tr>
<td>3</td>
<td>$2.56</td>
<td>$28.13</td>
<td>$0</td>
</tr>
</tbody>
</table>

Such interest would be an expense (as part of rent expense). The $69.95 right of use would be amortized, also resulting in expenses (the other part of rent expense). Any reasonable amortization method would be allowed, with straight-line as the default. In the example, if the lessee were to use straight-line amortization for the $69.95 right-of-use ($23.32 a year), the total rent expenses would be:

<table>
<thead>
<tr>
<th>Year</th>
<th>Interest</th>
<th>Amort.</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$6.99</td>
<td>$23.32</td>
<td>$30.31</td>
</tr>
<tr>
<td>2</td>
<td>$4.89</td>
<td>$23.32</td>
<td>$28.21</td>
</tr>
<tr>
<td>3</td>
<td>$2.56</td>
<td>$23.32</td>
<td>$25.88</td>
</tr>
</tbody>
</table>

The $84.40 of total rent (three years of $28.13 a year) would be expensed, but more quickly than expensing the stated level rent each year.

To FASB and IASB, the most important feature of this accounting is that it results in more useful balance sheets. In the example, both the lessor and the lessee would show a $69.95 asset and a $69.95 liability at the beginning of the lease, with those amounts adjusted over the life of the lease, as just discussed. Further, if the used equipment market declines substantially, the lessee would be required to write the right-of-use asset down, with this impairment loss reducing profits. If the lessee gets in financial trouble, the lessor would write the lessee’s obligation to it down, which would reduce the lessor’s profits.

To a tax expert, however, the most interesting feature of the proposal is that it would accelerate the recognition of rent revenue and expense. In the

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22 The closing balance is the opening balance plus accrued interest less the payment. So, in the first year, the closing balance is the initial $69.95 plus the $6.99 (10%) interest less the $28.13 rent payment.
example above, the rent booked in the first year under the FASB/IASB proposal is $30.31 rather than the $28.13 under the current rules. This accelerated rent recognition more accurately reflects the economics of the lease than does the current accounting. To see this, one must consider how the $28.13 amount of annual, year-end rent was arrived at.

First, consider the amount of rent that the leasing company would charge each year if the company were to rent the machine in five separate, consecutive, one-year leases. This amount can be determined based on (i) the information in the used machinery market noted above, which indicates that the machine will lose $20 of its market value each year, and (ii) the assumption that a market rate of interest is ten percent.

At the beginning of the machine’s first year, the company has $100 invested in the machine. So, the first year’s rent should include the usual ten percent annual return on investment, here, $10. Also, the machine will lose $20 of value in the first year, so the rent also should cover that depreciation cost. As a consequence, the first year’s rent would be $30.23 The same analysis suggests the following rent schedule over the five-year life of the machine:

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation</th>
<th>Return on Investment</th>
<th>Rent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$20</td>
<td>$10 (10% x $100)</td>
<td>$30</td>
</tr>
<tr>
<td>2</td>
<td>$20</td>
<td>$8 (10% x $80)</td>
<td>$28</td>
</tr>
<tr>
<td>3</td>
<td>$20</td>
<td>$6 (10% x $60)</td>
<td>$26</td>
</tr>
<tr>
<td>4</td>
<td>$20</td>
<td>$4 (10% x $40)</td>
<td>$24</td>
</tr>
<tr>
<td>5</td>
<td>$20</td>
<td>$2 (10% x $20)</td>
<td>$22</td>
</tr>
</tbody>
</table>

Consequently, under the assumed facts, the annual economic rent, which is implicit in the prices in the used equipment market, decreases as the machine gets older. This is no surprise; newer machines are more reliable and productive.24

Now, consider a three-year lease that commences when the machine is

---

23 Rent accrues continuously over a year. So, year-end rent contains a small amount of interest compared to daily or monthly interest, and beginning-of-year rent reflects the lessee earning the analogous small amount of interest. This article glosses over this nuance in the interests of simplicity.

24 Mundstock, Lease II, supra note 2, at 690–91.
first acquired. The lease could provide for $30 of year-end rent in the first year, $28 in the second, and $26 in the third. More likely, the lease would provide for level rent of $28.13 a year (for total rent of $84.40). The payments required under this level-rent lease have the same $69.95 present value (in a world where the annual rate of interest is ten percent) as the three payments of economic rent. The total stated rent is larger with level rent because payments will be made later in time. With level rent, the lessee underpays in the early years of the lease and overpays in the later years, with the later-year overpayments paying the lessor back for the early underpayments plus interest.25

Now, it is possible to compare the patterns of revenue and expense recognition for this level-stated-rent lease under (i) the current accounting rules, (ii) the FASB/IASB proposal, and (iii) economic accounting:

<table>
<thead>
<tr>
<th>Year</th>
<th>Current</th>
<th>Proposal</th>
<th>Economic</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$28.13</td>
<td>$30.31</td>
<td>$30.00</td>
</tr>
<tr>
<td>2</td>
<td>$28.13</td>
<td>$28.21</td>
<td>$28.19</td>
</tr>
<tr>
<td>3</td>
<td>$28.13</td>
<td>$25.88</td>
<td>$26.21</td>
</tr>
</tbody>
</table>

The proposal’s accounting more closely approximates the true economics than does merely booking the stated level rent. The longer the term of the lease, the more that level-rent accounting misses the economics. This article’s Appendix discusses this divergence and explains the reasons for the small difference between the proposal’s bookkeeping and economic accounting.

The discussion thus far provides the basis for analyzing the tax-related consequences of the FASB/IASB proposal.

25 If there were no cost for doing so, a lessee under a level-rent lease would break the lease before the lease begins to require rent that is higher than the economic rent, but leases contain termination penalties and there are other costs of breaking a lease, such as the costs of securing, installing, and testing replacement property. Mundstock, Lease II, supra note 2, at 693–97.

26 Economic accounting reflects interest to the extent that the stated rent is less than the economic rent. So, in the example, as to the first year of the lease, the economic rent is $30, yet the lease only requires a rent payment of $28.13. Thus, $1.87 ($30 - $28.13) is borrowed at year end. See supra note 23. As a consequence, in the second year, the total cost of leasing the property is the $28 of second-year economic rent plus 19¢ of interest (10% of the borrowed $1.87) for the $28.19 of total expense shown in the table. Similarly, there is 21¢ of interest in the third year, so that the total expense is the 21¢ of interest and the $26 of economic rent, as shown in the table.
III. FINANCIAL ACCOUNTING FOR INCOME TAXES

The FASB/IASB proposal, by changing the timing of rent revenue and expense for financial accounting purposes, also would change the financial accounting for income tax expense of both lessors and lessees. Financial accounting books the expense for income taxes when the income that triggers the tax is recorded on the financial books, not when that income is taxed under the relevant tax accounting.\(^\text{27}\) Accordingly, because under the FASB/IASB proposal the lessor would book revenue more quickly than currently, the proposal would accelerate income tax expense for financial accounting purposes.\(^\text{28}\) This is sound financial accounting because the faster financial accounting for profits would appropriately be reduced by the taxes expected to be associated therewith. Similarly, for financial accounting purposes, the lessee would show rent expense more quickly, which would reduce the lessee’s profits in the early years of a lease compared to the current accounting. This acceleration of expenses would defer some income tax expense for financial accounting purposes.\(^\text{29}\)

IV. TAX EFFECTS OF THE FINANCIAL ACCOUNTING CHANGE

A. Tax Accounting Method Impact

The question arises as to how adoption of the FASB/IASB proposal would affect a taxpayer’s federal income tax accounting method. Current regulations block lessees from deducting unpaid rent more quickly than under level-rent accounting.\(^\text{30}\) As to lessors, the tax law gives the Service considerable discretion to change a taxpayer’s tax accounting method when the taxpayer’s current tax method does not “clearly reflect income.”\(^\text{31}\) The

\(^{27}\) ACCOUNTING STANDARDS CODIFICATION, supra note 9, § 740-10-10-1.

\(^{28}\) This tax expense may be booked for financial accounting purposes before the tax actually is owed because tax accounting generally respects level rent. See infra text accompanying notes 64–78. If so, the financial accounting that supports the accelerated expense involves increasing an accrued tax liability or reducing a deferred tax asset. ACCOUNTING STANDARDS CODIFICATION, supra note 9, § 740-10-25-2.

\(^{29}\) The financial accounting that supports the deferred expense involves reducing a deferred tax liability or increasing a deferred tax asset. ACCOUNTING STANDARDS CODIFICATION, supra note 9, § 740-10-25-2.

\(^{30}\) Treas. Reg. § 1.461-4(d)(3) (as amended in 2004). Below, this article suggests changing this tax law. See infra text accompanying notes 64–78. Also, the Service has considerable power to prevent a taxpayer from changing its tax accounting method. See I.R.C. § 446(e).

\(^{31}\) I.R.C. § 446(b); see generally MICHAEL B. LANG, ELLIOTT MANNING & MONA L. HYMEL, FEDERAL TAX ACCOUNTING 35–42 (2d ed. 2011); STEPHEN F. GERTZMAN, FEDERAL TAX ACCOUNTING ch. 2 (2010). The Service has even broader powers when a taxpayer
courts, however, have been clear that financial accounting practice, while relevant,\textsuperscript{32} does not necessarily control whether an accounting method so clearly reflects income. Much of the case law here involves the Service attempting to change a taxpayer’s tax accounting method from the cash basis (which is not proper financial accounting) to the accrual method of tax accounting (which more closely approximates financial accounting\textsuperscript{33}).\textsuperscript{34} The Service has had few victories here.\textsuperscript{35} A big reason for the courts’ rejection of a requirement that a taxpayer use financial accounting’s accrual approach in the taxpayer’s tax accounting was that Congress explicitly indicated that the cash method would be acceptable in some cases; so implicitly, the cash method can clearly reflect income.\textsuperscript{36} With regard to leasing, section 467 of the Code indicates that Congress is comfortable with level tax accounting for rent.\textsuperscript{37} Under these circumstances, it seems unlikely that the Service would be successful in accelerating the recognition of lessors’ rental income for federal income tax purposes solely because of a change in financial accounting. Later in this article, it is suggested that the tax law should adopt the approach of the FASB/IASB proposal legislatively.\textsuperscript{38}

B. Capital Stock Taxes

The FASB/IASB proposal could change the state and local tax liabilities of lessors and lessees.\textsuperscript{39} New financial accounting certainly would change liabilities for taxes that use a taxpayer’s financial accounting to determine the amount of tax. For example, a few states impose a corporate franchise, bank franchise, or doing business tax that is measured by the amount of equity shown on the taxpayer-corporation’s financial statements (apportioned to the taxing state).\textsuperscript{40} The changed timing of rent revenue and expense under the FASB/IASB proposal would accelerate lessors’ liabilities

\begin{footnotes}
\footnotetext[32]{Treas. Reg. § 1.446-1(a)(2)(as amended in 2011).}
\footnotetext[33]{See generally GEORGE MUNDSTOCK, A FINANCE APPROACH TO ACCOUNTING FOR LAWYERS ch. VI (2d ed. 2006).}
\footnotetext[34]{The regulations require a business with inventories to use an accrual method. Treas. Reg. § 1.446-1(a)(4)(i), -1(c)(2)(i) (as amended in 2011).}
\footnotetext[35]{LANG, MANNING & HYMEL, supra note 31, at 17; GERTZMAN, supra note 31, ¶ 3.08.}
\footnotetext[36]{I.R.C. § 446(c)(1).}
\footnotetext[37]{I.R.C. § 467(a), (b); see Treas. Reg. § 1.467-1(a) (as amended in 2001).}
\footnotetext[38]{See infra text accompanying notes 64–78.}
\footnotetext[39]{See generally Thomas Jaworski, Companies Identify Tax Issues Tied to FASB-IASB Leasing Proposal, 130 TAX NOTES 170 (Jan. 10, 2011).}
\footnotetext[40]{RESEARCH INST. OF AM., ALL STATES TAX GUIDE §§ 240, 241 (2011) [hereinafter RIA GUIDE].}
\end{footnotes}
Under such taxes and defer lessees' liabilities.

C. Personal Property Taxes

Many states and localities impose taxes on personal property, however, few of these taxes reach intangible assets. Consequently, the question under such personal property taxes would be whether the right-of-use asset of a lessee in tangible personal property itself should be viewed as tangible. Also, property taxes usually are imposed on the fair market value of property. The fair market value of a right of use is unclear. However, state and local property tax assessors frequently use depreciated cost as one indicator of fair market value. Lessees' financial statements would show an amortized cost for the right of use. So, the right-of-use asset (at amortized cost) could be the subject of ad valorem personal property taxation.

D. State and Local Income Taxes

Interesting questions are presented as to how, if at all, the FASB/IASB proposal would impact state and local income taxes. Above, it was argued that the proposal's new financial accounting by itself should not change federal income tax accounting. A similar analysis should apply with respect to state and local income taxes, so that adoption of the FASB/IASB proposal should not change taxpayers' relevant tax accounting.

The FASB/IASB proposal could change taxpayers' actual state and local tax liabilities, however, by changing the allocation and apportionment of income among taxing jurisdictions. States and localities that impose an income tax (i) sometimes tax residents, domiciled individuals, and corporations on their entire income (with relief for double taxation), and (ii)

41 Id. §§ 260, 264.
42 Id.
43 Another question is whether a right of use in real property, if tangible, is personal or real property.
44 RIA GUIDE, supra note 40, §§ 260, 264.
45 One value-related issue is whether the asset should be reduced by the related obligation to pay rent.
47 See supra text accompanying notes 30–38.
48 Many state and local income taxes expressly incorporate the federal income tax accounting rules. HELLERSTEIN & HELLERSTEIN, supra note 46, at 435.
sometimes tax their residents and domiciles only on income viewed as attributable to the taxing jurisdiction. In almost all states and localities that impose an income tax, nonresidents’ and non-domiciliaries income is taxed if it is viewed as attributable to the taxing jurisdiction. Under these circumstances, if a taxing jurisdiction views the FASB/IASB proposal as re-characterizing leases, the proposal could change how the jurisdiction determines the portion of the income of multi-jurisdictional taxpayers that is subject to the local taxing power.

Under state and local tax law, the taxable income attributable to the relevant taxing jurisdiction is determined using both specific allocation rules and general apportionment rules. For example, rental income of a lessor of tangible property when that property is not used as part of a larger business usually is allocated to the location of the property. In contrast, overall business income, including business rental income, is apportioned using various formulae. These formulae usually use the portion of the total property, payroll, and/or sales in the taxing jurisdiction to determine the portion of the business’s income in the jurisdiction, with varying weights given to these factors.

Allocation and apportionment issues would arise if states and localities view the adoption of the FASB/IASB proposal as changing the character of lease transactions. For example, if nonbusiness rental income, which currently is allocated to where the property is situated, is treated as having an interest component, that interest component would likely be re-sourced to the state of the taxpayer’s residence or domicile.

Interestingly, many of the property factors that are used to apportion business income recognize the contribution of leased assets to a lessee business by requiring a lessee to treat leased property as an asset for purposes of the property factor. Leased property is valued at eight times

49 See Hellerstein & Hellerstein, supra note 46, at 940; Schoettle, supra note 46, at 477-81, 577-83.
50 Schoettle, supra note 46, at 521, 577-83.
51 See Hellerstein & Hellerstein, supra note 46, at 437-40.
54 UDITPA provides that one-third of income is allocated by property, one-third by sales, and one-third by payroll. UDITPA § 9, 7A U.L.A. at 168. Many states now use a single sales factor. Healy & Schadewald, supra note 52, at 5007-13.
56 UDITPA § 10, 7A U.L.A. at 176.
the net annual rent.\textsuperscript{57} If state and local income tax law followed the approach of the FASB/IASB proposal, this eight-times-rent value for leased property would be replaced with a right-of-use asset that is valued at the present value of all future rent with no amortization.\textsuperscript{58} This could change apportionment somewhat.

For purposes of the sales factor used to apportion business income, business rental income customarily generates sales in the state where the property is located.\textsuperscript{59} The proposal’s approach would divide rent into a use component and a finance component. A taxing jurisdiction could follow this bifurcation in applying the sales factor. The use component presumably would continue to be treated as a sale in the state where the property is situated. Interest income, however, can be treated as a sale at the location of the office responsible for the transaction or the commercial domicile.\textsuperscript{60} Consequently, the proposal could support a new sales location for the interest component of rent.

\textbf{E. Sales and Use Tax}

States and localities also impose sales and use tax on many rentals of tangible personal property.\textsuperscript{61} If the FASB/IASB proposal is viewed as changing the timing of rent, it would accelerate these taxes. If the proposal is viewed as treating all leases over twelve months as sales of a right of use, it could accelerate these taxes even more (although the tax would apply

\textsuperscript{57} UDITPA § 11, 7A U.L.A. at 177.

\textsuperscript{58} Id. Presumably, the right-of-use asset would be viewed as tangible property that is situated where the leased asset is located.

\textsuperscript{59} UDITPA § 17, 7A U.L.A. at 186; Allocation and Apportionment Regulations, MULTISTATE TAX COMM‘N, § IV.17(4)(B)(a) (July 29, 2010), http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocationandApportionmentReg.pdf. The Multistate Tax Compact, to which a number of states are parties, contains allocation and apportionment rules that are identical to UDITPA, so that the administrator of the Compact, the Multistate Tax Commission, has provided model apportionment regulations. See HELLERSTEIN & HELLERSTEIN, supra note 46, at 605–06; SCHÖETTLE, supra note 46, at 596–98.

\textsuperscript{60} See Allocation and Apportionment Regulations, supra note 59, § IV.17(1) - (4)(A); UDITPA § 7, 7A U.L.A. at 165.

only to the present value of the lease rent). Importantly, however, the Streamlined Sales and Use Tax, which has been adopted in twenty-four states, expressly provides that the characterization of a transaction for financial accounting purposes is not relevant for purposes of sales and use tax determinations. 62

V. TAX ACCOUNTING REFORM

An obvious question is whether the FASB/IASB’s proposed approach is a desirable reform to U.S. income tax accounting law. Because the proposal’s accounting more accurately reflects the economics of a lease, as noted above, the answer is yes. 63

Under current tax accounting, lessees generally account for rent in a level fashion. 64 If the FASB/IASB proposal were to become effective for financial accounting purposes, lessees (who use an accrual method for tax accounting purposes 65) will think it only fair that they be allowed the same, faster deductions for tax purposes as for financial accounting purposes. There are many situations, however, where the tax law does not allow deductions for expenses at the time that they are accrued for financial accounting purposes. For example, additions to returns, tort liability, and warranty reserves for estimated future outlays are not allowed as tax deductions. 66 These deductions are allowed only when the associated amounts are paid. 67 A lease, however, is different. The current deferral of such reserve-related deductions was motivated by a concern that accrual-basis taxpayers not take excessive deductions — deductions for overestimated amounts to be paid well in the future with no discounting of such amounts to reflect the time value of money. 68 With leasing, the FASB/IASB proposal takes the time value of money into account so that this concern does not apply. Also, while in the reserve-related deduction situations, the

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62 SSUTA app. C, pt. I (definition of “Lease or rental”).
65 Cash basis taxpayers are not allowed deductions for unpaid, accrued items. Treas. Reg. §§ 1.446-1(c)(1)(ii) (as amended in 2011), 1.461-1(a)(1) (as amended in 1999). Even original issue discount, which is taxable to cash basis taxpayers regardless of when it is to be received, frequently is not deductible by cash basis taxpayers. I.R.C. §§ 163(e), 163(h)(1), 1272, 1275(b). Because of these rules, this article only suggests accelerating deductions for accrual basis taxpayers.
66 I.R.C. § 461(h). There is an exception for recurring items. I.R.C. § 461(h)(3).
67 Id.
amount of future outlays is uncertain, for leases, the portion of future rent payments incurred currently is readily measurable and, if all goes as planned, will be paid. The later rent payments owed may be dischargeable in bankruptcy by return of the leased property, but that uncertainty does not seem different in kind from the general risk of nonpayment that the tax law ignores in accruing items of deduction.

As to the lessor, matters are flipped: rent currently is taken into income in a level fashion. The government should want lessors to pay tax currently on the economic rent attributable to the current year even if a portion of that amount will be received in the future (for both accrual and cash basis lessors). This hidden rent resembles original issue discount, which is taxed yearly under current law to both accrual and cash basis taxpayers. This acceleration of the tax on rent revenue is supported by the general policy that the tax law should resolve uncertainties in favor of taxation. The tax accounting regulations have long stated that an accrual basis taxpayer is taxed on an item of gross income when "the amount thereof can be determined with reasonable accuracy." For example, in a sale of inventory for future payments, the entire sales price is taxed even though there is a real but small possibility of nonpayment. Financial accounting deals with the possibility of nonpayment through the bad-debt reserve, which is not permissible under current tax law.

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69 Mundstock, Lease II, supra note 2, at 696–97.
71 I.R.C. § 467(a), (b); see Treas. Reg. § 1.467-1(a) (as amended in 2001). Even with regard to an accrual basis taxpayer, prepaid rent received is taxed immediately, while advance rent paid is not deductible until the period to which the rent relates. Treas. Reg. §§ 1.61-8(b), 1.461-4(d)(3)(i). This article does not evaluate the immediate taxation of advance rent received by an accrual basis taxpayer.
72 Mundstock, Lease II, supra note 2, at 700–06; Mundstock, Lease I, supra note 2, at 354–55.
73 I.R.C. § 1272(a).
74 Examples include Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979) (A taxpayer is not entitled to deduct a loss with respect to property worth less than its cost even though the taxpayer is required to take such loss for financial accounting purposes.); Schlude v. Commissioner, 372 U.S. 128 (1963) (A dance school is immediately taxable on membership dues received even though the dues would have to be returned if services are not provided.); James v. United States, 366 U.S. 213 (1961) (An embezzler is taxed on embezzled funds since it intends to keep the funds, even though the embezzler may be required to disgorge the funds later.); and Crane v. Commissioner, 331 U.S. 1 (1947) (The tax law assumes that the owner of property subject to nonrecourse debt will pay the debt even though not legally obligated to do so.).
75 Treas. Reg. § 1.451-1(a) (as amended in 1999).
76 I.R.C. § 453(b)(2).
In short, adopting the approach of the FASB/IASB proposal for purposes of federal income tax accounting would effect a real improvement in the law.

VI. BETTER ACCOUNTING PROVIDES BETTER SOURCING

The approach of the FASB/IASB proposal could be used to improve the federal income tax rules that determine the source of income of U.S. multinational businesses.

The United States taxes the worldwide income of U.S. persons. The U.S. international tax regime is markedly different from how U.S. states and localities sometimes tax only income that is attributable to their jurisdiction, as discussed above. To prevent double taxation, the United States allows a credit for foreign income taxes. The credit is limited to the U.S. tax on foreign-source income. Complicated rules determine the source of income for purposes of calculating the amount of U.S. tax on foreign-source income. If a U.S. multinational pays only low-rate foreign taxes, the details of these sourcing rules are of limited importance because the foreign taxes likely will be fully creditable as long as a substantial portion of the multinational’s income is treated as foreign-source. As to a U.S. multinational that does business in high-tax foreign countries, however, every extra dollar of net income that can be treated as foreign-source is effectively exempt from U.S. income taxes because, while this dollar generates U.S. tax, that tax is offset by the increased foreign tax credit (the amount equal to the dollar multiplied by the taxpayer’s average U.S. tax rate). For such a business, sourcing rules play a key role in international tax planning.

The artful use of leasing helps some U.S. multinationals maximize their foreign tax credits. If a U.S. multinational borrows money and invests the

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78 I.R.C. § 461(h).
80 See supra text accompanying notes 49–60.
81 I.R.C. § 901.
82 I.R.C. § 904. There is a one-year carryback and a ten-year carryforward of any foreign taxes that are not allowed as a credit in the current year because the total foreign taxes exceed the credit limit. I.R.C. § 904(c). This article does not reflect the complexity of the various sub-limits (baskets) on the foreign tax credit. See I.R.C. § 904(d).
83 On 2006 returns, U.S. companies had $108 billion of creditable taxes but were only allowed total credits of $78 billion. Nuria McGrath, Corporate Foreign Tax Credit 2006, STAT. OF INCOME BUL., Summer 2010, at 118, 118, 133.
Lease Accounting

borrowed funds in the United States, some of the interest paid on that debt is treated as foreign-source interest, so as to potentially reduce the foreign tax credit.\footnote{I.R.C. § 864(e); Treas. Reg. § 1.861-9T(a) (as amended in 2012). Under current U.S. federal tax law, interest expense is apportioned between U.S. and foreign sources based on the respective values of U.S. and foreign assets without regard to where the funds are borrowed or used.} This is because the current U.S. rules for interest deduction sourcing are based on the notion that money is fungible: any borrowing — wherever effected and wherever the proceeds are utilized — is viewed as benefitting all of the worldwide components of a business.\footnote{James R. Hines, Jr. & Kenneth A. Froot, *Interest Allocation Rules, Financing Patterns, and the Operations of U.S. Multinationals*, in *The Effects of Taxation on Multinational Corporations* 277–307 (Martin Feldstein, James R. Hines, Jr. & R. Glenn Hubbard eds., 1995). This Hines and Froot piece was the principal motivation for this article. In unusual circumstances, property leased in the United States can have a relationship with foreign-source income such that a portion of the rent expense is foreign-source. Treas. Reg. § 1.861-8 (as amended in 2009). This nuance is not reflected in the text.} As a consequence, interest on any borrowing must be apportioned worldwide. In contrast, if the multinational leases property in the United States, all of the associated rent expense is U.S.-sourced, so as not to impact the multinational’s foreign tax credit limit.\footnote{Daniel Shaviro, *Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals*, 54 *Tax L. Rev.* 353 (2001).} One can question the soundness of the fungibility approach to allocating interest.\footnote{Alternatively, one can view leasing as the reductio ad absurdum of the fungibility approach.} That does not mean, however, that leasing should be encouraged as a way around the application of the current interest allocation rules.\footnote{Proposition for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM (2011) 121/4 (Mar. 11, 2011) [hereinafter CCCTB Proposal]; See Mundstock, *E.U. Tax Policy*, supra note 79, at 738–41, 749–54.}

European Union among these countries using a three-factor (property, payroll, and sales) apportionment formula (much like those used by states and localities in the U.S, as discussed above\(^91\)).\(^92\) As noted above, the U.S. federal income tax generally uses apportionment only for interest deductions, with special allocation rules for most other items of income and deduction. Because the Commission’s proposal relies exclusively on apportionment for sourcing, the Commission’s staff gave considerable attention to the CCCTB’s apportionment rules.\(^93\) The CCCTB provides that, for purposes of determining a taxpayer’s property in the various countries, a lessee is treated as owning property that is valued at eight times the annual rent (which, as noted above, is a common rule in U.S. state and local income tax apportionment formulae\(^94\),\(^95\)).

The FASB/IASB proposal’s approach, if applied to U.S. federal income tax law for deduction sourcing purposes, would treat borrowing and leasing similarly. Economically, leasing involves both the use of property and the financing of that property.\(^96\) The FASB/IASB approach bifurcates a lease into its use and finance components. Then, the U.S. tax law can apply the proper — and different — sourcing rules to each of the components. When a U.S. multinational leases property in the United States, the interest on the obligation to make payments would be sourced as if it were regular interest (i.e., in accordance with the fungibility approach). The right-of-use amortization expense would be sourced where the property is used.\(^97\) As a consequence, the benefits from the artful use of leasing to avoid the fungibility-approach-based rules for sourcing interest deductions would be considerably reduced.\(^98\)

VII. CONCLUSION

If FASB and IASB implement their sound proposal, the tax community will be affected. It will cause some confusion as to the impact of the

\(^91\) See supra text accompanying notes 52–53.
\(^92\) CCCTB Proposal, supra note 89, at 49.
\(^93\) Treas. Reg. § 1.861-8(a) (as amended in 2009).
\(^95\) CCCTB Proposal, supra note 89, at 51.
\(^96\) Leasing II, supra note 2, at 687–94.
\(^98\) The Appendix explains how the FASB/IASB proposal would not fully capture the portion of rent that resembles interest.
financial accounting change on tax liability. More interestingly, however, adopting the approach of the FASB/IASB proposal in the tax law would improve the law, including in how it sources the income of multinational businesses.
APPENDIX

This Appendix explains why the FASB/IASB proposal, while it would improve both the current financial accounting rules for operating leases and current U.S. tax law, does not fully capture the economics of leasing.

Reconsider the example used in the text: a machine costs $100 and will last exactly five years. The machine will lose $20 of value in each of these five years. The market rate of interest is ten percent a year. For simplicity, at this point, the discussion assumes that rent is paid once a year, at year end. Later, the calculations will be redone with beginning-of-year rent. Under these assumptions, the annual economic rent on the machine (of course, making the customary assumptions about efficient markets) would be as follows:

<table>
<thead>
<tr>
<th>Year</th>
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<tr>
<td>1</td>
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<tr>
<td>2</td>
<td>$28</td>
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<td>$26</td>
</tr>
<tr>
<td>4</td>
<td>$24</td>
</tr>
<tr>
<td>5</td>
<td>$22</td>
</tr>
</tbody>
</table>

Each year, the lessor recovers the economic depreciation ($20 a year) plus a profit of ten percent of its unrecovered investment (cost less the amount of this investment that has been recovered through the economic depreciation component of rent).

The FASB/IASB proposal understates the implicit borrowing in a lease. The proposal treats the lessee as acquiring a right of use, not the entire property. While the lessor cannot use the property during the lease term, it must finance the entire value of the leased property, including the value attributable to future use after lease termination. The final payment of “principal” in the loan component of a lease is the return of the leased property by the lessee to the lessor at the end of the lease. Economic rent includes interest on the lessor’s entire, unrecovered investment.

Now, it is possible to compare the FASB/IASB proposal with economic accounting. To enrich the example, it is helpful first to determine the level stated rent, with the same present value as the economic rent, of leases of varying lengths:

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99 FASB rejected this notion outright, for no apparent reason. FASB DISCUSSION PAPER, supra note 1, ¶¶ 3.22–3.25. One can speculate, however, that the right-of-use model was chosen because it is an intellectual compromise between the current accounting rules and a regime that treats all leases as financings of the entire property.
Next, for these five leases, compare the interest component of rent under economic accounting and the FASB/IASB proposal:

**FASB/IASB**

<table>
<thead>
<tr>
<th>Year</th>
<th>1 Year</th>
<th>2 Years</th>
<th>3 Years</th>
<th>4 Years</th>
<th>5 Years</th>
</tr>
</thead>
<tbody>
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<td></td>
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<td>$2.64</td>
<td></td>
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</tr>
</tbody>
</table>

**Economic**

<table>
<thead>
<tr>
<th>Year</th>
<th>1 Year</th>
<th>2 Years</th>
<th>3 Years</th>
<th>4 Years</th>
<th>5 Years</th>
</tr>
</thead>
<tbody>
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<tr>
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<td>$8.10</td>
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<tr>
<td>3</td>
<td>$6.19</td>
<td>$6.38</td>
<td>$6.56</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>$4.29</td>
<td></td>
<td></td>
<td>$4.58</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td></td>
<td></td>
<td></td>
<td>$2.64</td>
<td></td>
</tr>
</tbody>
</table>

The larger the expected residual value of the leased property at the end of the lease (i.e., the shorter the lease term is compared to the economic life of the leased property), the more the FASB/IASB proposal understates the hidden interest in a lease. The associated understatement of the interest component of rent would be of particular interest if the FASB/IASB approach were applied for purposes of sourcing the income of U.S. multinational businesses because the interest component of rent would be sourced differently from the use portion of rent, as discussed above.\(^{101}\)

Finally, as to the five, year-end rent, level-rent leases, compare the accounting under the FASB/IASB proposal (with straight-line amortization

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\(^{100}\) The level rent is the equal, annual, beginning-of-year payments with the same present value (at ten percent annual interest) as the economic rent in table 3.

\(^{101}\) See supra text accompanying notes 79–88.
of the right of use) with economic accounting: ¹⁰²

Length of Lease

<table>
<thead>
<tr>
<th>Year</th>
<th>1 Year</th>
<th>2 Years</th>
<th>3 Years</th>
<th>4 Years</th>
<th>5 years</th>
</tr>
</thead>
<tbody>
<tr>
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<td>EC</td>
<td>FASB</td>
<td>EC</td>
<td>FASB</td>
</tr>
<tr>
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<td>$30.00</td>
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<td>$22.40</td>
<td>$22.40</td>
<td>$22.40</td>
<td>$22.40</td>
<td>$22.40</td>
</tr>
</tbody>
</table>

Note that the FASB/IASB proposal (with level amortization of the right of use) matches economic accounting only in the one-year and five-year cases. Nevertheless, the proposal is fairly close to the economics, and thus is a vast improvement over the current tax and financial accounting rules.

The FASB/IASB proposal contemplates that a lessee can chose an amortization method for the right of use (or, in the case of a lessor, the obligation to provide use) so that the financial accounting mirrors the economics.¹⁰³ Even with such amortization, however, the proposal still would understate the financing (interest component) involved in a lease, which would be important if this approach was used for deduction sourcing purposes.

The conclusions are the same if rent is to be paid at the beginning of each year. In this case, the economic rent is:

<table>
<thead>
<tr>
<th>Year</th>
<th>Economic Rent¹⁰⁴</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
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<tr>
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<td>$21.82</td>
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<tr>
<td>5</td>
<td>$20.00</td>
</tr>
</tbody>
</table>

The beginning-of-year level rents in the various term leases with the same present value as the economic rent are:

¹⁰² Remember that level rent involves borrowing, so that under economic accounting the rent amount is different from economic rent.

¹⁰³ FASB/IASB LEASE PROPOSAL, supra note 1, ¶ 20, 37(b), 38.

¹⁰⁴ The beginning-of-year economic rent is easiest to see if viewed as the year-end economic rent above discounted for one year at a ten percent annual yield.
### Length of Lease

<table>
<thead>
<tr>
<th>Year</th>
<th>1 Year</th>
<th>2 Years</th>
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<th>4 Years</th>
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<td>FASB</td>
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<td>20.00</td>
<td></td>
</tr>
</tbody>
</table>

Now, under the five leases, compare the accounting under the FASB/IASB proposal (with straight-line amortization of the right of use) to economic accounting:

### Length of Lease

<table>
<thead>
<tr>
<th>Year</th>
<th>1 Year</th>
<th>2 Years</th>
<th>3 Years</th>
<th>4 Years</th>
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<tbody>
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<td>FASB</td>
<td>FC</td>
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<td></td>
<td></td>
<td>20.00</td>
<td>20.00</td>
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</tr>
</tbody>
</table>

Finally, compare the interest component of rent under economic accounting and the FASB/IASB proposal:

### FASB/IASB

<table>
<thead>
<tr>
<th>Year</th>
<th>1 Year</th>
<th>2 Years</th>
<th>3 Years</th>
<th>4 Years</th>
<th>5 Years</th>
</tr>
</thead>
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### Economic

<table>
<thead>
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<th>Year</th>
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<th>3 Years</th>
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