Sales & Property Tax Lessor Relief Finalized

With the effective date impending for the new lease guidance for public entities,[1] the Financial Accounting Standards Board (FASB) recently finalized relief for lessors. Accounting Standards Update (ASU) 2018-20, *Leases (Topic 842): Narrow-Scope Improvements for Lessors*, addresses three issues:

- Sales taxes collected from lessees – FASB developed a new accounting policy election to exclude certain taxes from lease revenue and expense
- Lessor costs paid by lessees – A lessor is required to exclude lessor costs paid directly by a lessee to third parties on the lessor's behalf from the lease measurement. However, all lessee reimbursed costs—including property taxes—must be reported as revenue with a related expense
- Variable payments' allocation for contracts that contain lease and nonlease components – Lessors are required to allocate—rather than recognize—certain variable payments to a contract's lease and nonlease components when the uncertainty related to the variable payment changes

Effective Dates ASU 2016-02	**Public Entities** Annual and interim periods beginning after December 15, 2018	**All Others** Annual periods beginning after December 15, 2019

ASU 2016-02
Leases (Topic 842)

ASU 2018-01
Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842

ASU 2018-10
Codification Improvements to Topic 842, Leases

ASU 2018-11
Leases (Topic 842): Targeted Improvements

ASU 2018-20
Narrow-Scope Improvements for Lessors

Exposure Draft
Codification Improvements – Lessors

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[1] *A public entity is defined as any one of these:*

- *A public business entity*
- *A not-for-profit entity that has issued—or is a conduit bond obligor for—securities traded, listed or quoted on an exchange or over-the-counter market*
- *An employee benefit plan that files or furnishes financial statements to the SEC*

Sales Taxes Collected from Lessees

Currently, Accounting Standards Codification (ASC) 842 requires lessors to analyze taxes on a jurisdiction-by-jurisdiction basis to determine whether those taxes are the primary obligation of the lessor as owner of the lease's underlying asset or whether those taxes are collected by the lessor on behalf of third parties. When a tax is collected from a lessee on behalf of third parties, *i.e.*, lessor is acting as an agent, a lessor would exclude that amount from lease revenue. When the lessor is primarily obligated for payment of the tax, the lessor would include that amount gross—as a revenue and an expense.

Analyzing various taxes in multiple jurisdictions to determine net or gross presentation would be costly and complex. This ASU provides an accounting policy election for lessors similar to one in ASC 606. If elected, a lessor would exclude certain taxes from the contract's consideration and variable payments not included in the contract's consideration. To be excluded, the taxes must be assessed by a governmental authority and be both imposed on and concurrent with a specific lease revenue-producing transaction and collected by the lessor from a lessee, *e.g.*, sales, use, value-added and some excise taxes. Taxes assessed on a lessor's total gross receipts or on the lessor as owner of the underlying assets are out of scope for this election. Disclosure of the expedient is required, if elected.

Taxes levied on a lessor's gross revenue are excluded because FASB felt they are not a specific lease-producing revenue transaction, and the lessor likely would not be acting as an agent for a lessee with respect to those taxes. FASB concluded taxes on a lessor's gross receipts are more appropriately considered lessor costs and should be accounted for as lease revenue with a corresponding expense.

Costs Paid by Lessees

Lessors incur a variety of costs related to a lease's underlying asset. Frequently, lessees are required to pay some of those expenses (usually property taxes or insurance costs), either as a direct payment to a third party or as a reimbursement to the lessor. However, because those payments do not transfer a good or service to the lessee separately from the right to use the underlying asset, ASC 842 currently requires a lessor to report those amounts gross, as a revenue and an expense (see table below). This seems straightforward, but keeping track of these costs can be expensive and time-consuming. As written, ASC 842 would force lessors to estimate these costs, which may not provide financial statement users with meaningful information. This frequently happens because some of the costs are lessee-specific and may be unknown to the lessor. For example, a lessee may be required to insure its leased asset. The lessee may choose to insure both leased and nonleased assets under a comprehensive umbrella insurance policy with a single premium. Under this scenario, it would be unlikely for a lessee to disclose to the lessor the portion of a premium related to the leased asset. It also would be a challenge for a lessor to estimate the cost.

Lease Component	Nonlease Component	Not a Separate Component
• A separate right to use an asset • Lessee can benefit from the right of use (ROU) of the underlying asset either on its own or together with other readily available resources. The use is neither highly dependent on nor interrelated with other assets • **Payments accounted for as a separate lease**	• An activity that transfers a separate good or service to the customer • Includes maintenance services • **Allocated payments are nonlease period expense**	• Related to administrative tasks to initiate the lease and payment of lessor costs that do not transfer a separate good or service that is separate from the ROU asset • Includes payments for insurance or property taxes • **Payments are not part of lease payment and not separately allocated**

To provide relief, these amendments **require** a lessor to exclude from variable payments lessor costs paid by a lessee directly to a third party. However, if these excluded costs are reimbursed by a lessee, the lessor must include the amounts as variable payments, and the lessor will record those reimbursed costs as revenue.

Lease Payments					
Fixed lease payments	Certain variable payments	Purchase options	Termination penalties	Lessee-paid SPE structuring fees	RVG (lessee only)

The standard provides the following example to illustrate the relief provided:

Example – Payments for Taxes and Insurance Are Variable

Lessor and Lessee enter into a five-year building lease. The contract designates that Lessee is required to pay for the costs relating to the asset, including the real estate taxes and the insurance on the building. The real estate taxes would be owed by Lessor regardless of whether it leased the building and who the lessee is. Lessor is the named insured on the building insurance policy, i.e., the insurance protects Lessor's investment in the building, and Lessor will receive the proceeds from any claim. The annual lease payments are fixed at $10,000 per year, while the annual real estate taxes and insurance premium will vary and be billed by Lessor to Lessee each year.

The real estate taxes and the building insurance are not components of the contract. The contract includes a single lease component—the right to use the building. Lessee's payments of those amounts solely represent a reimbursement of Lessor's costs and do not represent payments for goods or services in addition to the right to use the building. However, because the real estate taxes and insurance premiums during the lease term are variable, those payments are variable lease payments that do not depend on an index or rate and are excluded from the measurement of the lease liability and recognized by Lessee.

The Lessor also recognizes those payments as variable lease payments because the real estate taxes and insurance premiums are paid by Lessor to the taxing jurisdiction and insurance company and reimbursed by Lessee to Lessor. However, if Lessee paid the costs directly to the third parties, those lessor costs would not be recognized by Lessor as variable payments.

All lessee reimbursed costs—including property taxes—will be reported as revenue with a related expense.

Variable Payments for Contracts with Lease & Nonlease Components

The third issue addressed is more of a technical correction rather than additional relief. The current guidance in ASC 842 requires lessors to recognize certain variable payment amounts in profit or loss in the period when the changes in facts and circumstances on which the variable payment is based occur, regardless of whether the payment partially relates to nonlease components. As written, this could result in a lessor recognizing revenue for a nonlease component in a different period than when control of the nonlease component is transferred under ASC 606. This ASU clarifies that after any uncertainty is resolved, the variable payments are first allocated between lease and nonlease components under ASC 842, and then other relevant guidance is applied for recognizing amounts allocated to the nonlease component.

Effective Date & Transition

Because this ASU's release date is so close to the new lease guidance's effective date, FASB provides special transition terms:

- For entities that have not yet adopted ASU 2016-02, the transition and effective date guidance of this ASU are the same as ASU 2016-02, *i.e.*, January 1, 2019, for calendar year-end public companies
- For entities that have already adopted ASC 842, the effective date should be the original effective date of ASU 2016-02. Entities may adopt these amendments either in the first reporting period ending after issuance, *i.e.*, December 31, 2018, or in the first reporting period following the ASU's issuance, *i.e.*, January 1, 2019. Early adopters of ASC 842 can adopt this ASU either on a prospective or retrospective basis

Conclusion

The adoption of ASC 842 will be complex and likely will require significant hours to correctly implement. BKD can help educate your team, provide implementation tools and assist with analysis and documentation. If you would like assistance in complying with the new leases standard, contact your trusted BKD advisor. BKD has prepared a library of **BKD Thoughtware®** on this issue. Visit our website to learn more.

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