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RECENT DEVELOPMENTS HAVE MADE LEASE TAX ACCOUNTING MORE COMPLEX

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Recent accounting and tax developments have increased the tax accounting complexities for both lessees and lessors. ASU 2016-02 (subsequently codified as ASC 842), issued in 2016 by the Financial Accounting Standards Board, made substantial modifications to lease accounting under generally accepted accounting principles (GAAP), which have been widely adopted. While the Internal Revenue Code has not incorporated the GAAP changes, the Tax Cuts and Jobs Act of 2017 made substantive changes that can affect lease accounting for tax purposes. Little has been written about the interplay between the modified GAAP rules and the accounting treatment for tax purposes. Consequently, many tax practitioners are unprepared to properly account for the GAAP and tax accounting differences after the ASC 842 regime is implemented. This article explores aspects of lease accounting for operating leases from both a GAAP and tax perspective. For lessees and lessors, the GAAP changes affecting operating leases are analyzed, followed by a discussion of the operative tax rules.

INTRODUCTION

When reporting lease transactions in tax returns, the starting point is usually the accounting records prepared in accordance with generally accepted accounting principles (GAAP). To properly account for such transactions for tax purposes, tax practitioners must understand both the GAAP lease accounting treatment and the differences with the corresponding tax rules.

In 1976, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 13 (FAS 13), which prescribes

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under what circumstances a lease is considered an operating lease and when a lease is considered a financing transaction.[1] Generally, an operating lease is a rental contract where the lessee is allowed to use the leased property for a specified term, while the benefits and burdens of ownership are retained by the lessor. Conversely, a financing lease is in substance a financing transaction in the form of a lease, where the benefits and burdens of ownership are transferred to the lessee, and the lessor is treated as loaning the money to finance the lessee's acquisition.

Financial accounting scandals in the early 2000s involving the use of leases to create off-balance-sheet financing prompted a review of the principles set forth in FAS 13, which ultimately led to the issuance of Accounting Standards Update No. 2016-02 (ASU 2016-021), codified as ASC 842.[2] Since 2016, the FASB continues to provide guidance in response to questions that arise as a result of implementing ASC 842. While ASC 842 is complex and covers many areas, this article is limited to its provisions that impact tax planning and tax return preparation for operating leases.[3]

The effective date for adopting ASC 842 varies depending upon the nature of the issuer of financial statements. For public companies, other SEC registrants, and nonprofit issuers of publicly traded debt instruments, ASC 842 was effective no later than their first fiscal year beginning after December 15, 2018. ASC 842 is effective for years beginning after December 15, 2021, for all other entities that report financial statements on a GAAP basis.[4] While companies utilizing GAAP either have adopted or will adopt ASC 842, many smaller businesses instead may use the AICPA *Financial Reporting Framework for Simple Business Entities*, which allows for the continued use of FAS 13 methodology.[5]

The historical differences between GAAP and tax accounting for financing leases still exist. Many leases are financing transactions for GAAP purposes under FAS 13 (and now ASC 842) that do not meet the criteria to be treated as financing leases for tax purposes established in 1955 in Revenue Procedure 55-540.[6] Surprisingly, despite significant evolution in leasing business practices over the past 70 years, the Internal Revenue Service (IRS) has not shown much interest in updating the revenue procedure. In 2017, the Tax Cuts and Jobs Act of 2017 (TCJA)[7] modified § 451 to require the inclusion for tax purposes of certain gross

[1] FASB, Statement of Financial Accounting Standards No. 13 (Nov. 1976) [hereinafter "FAS 13"].
[2] FASB, Accounting Standards Update No. 2016-02, Leases (Topic 842) (Feb 2016) [hereinafter "ASU 2016-02"].
[3] Under ASC 842, lessees are generally required to record all leases on the balance sheet, irrespective of whether they are operating leases or financing leases. Lessors are not impacted as significantly by ASC 842 unless they engage in sale-leaseback transactions.
[4] Accounting Standards Update 2021-09—Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities, at 2 (Nov. 2021).
[5] AICPA, *Financial Reporting Framework for Simple Business Entities*, at 136-37 (Nov. 2017).
[6] 1955-2 C.B. 39.
[7] Pub. L. No. 115-97, 131 Stat. 2054 (2017). The TJCA is officially known as "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

income items simultaneously with the reporting of such amounts for financial statement purposes. While this provision has minimal impact on lessees, lessors commonly find that this change unexpectedly accelerates rental income for tax purposes.

The discussion in Parts I and II of this article compares the GAAP and tax treatment of operating leases from both the lessee and lessor perspectives. Part III discusses situations where § 467 controls lease tax accounting. Two examples are provided to illustrate how the rules interact with one another. A thorough understanding of the presented materials will provide tax practitioners with the knowledge needed to ensure that operating leases are properly accounted for.

I. LESSEE ACCOUNTING

A. *ASC 842*

The underlying principle of ASC 842 is that a lessee should recognize the assets and liabilities that arise in connection with a lease arrangement.[8] Generally, a lessee measures a lease liability at the present value of the future lease payments using a discount rate equal to the "Rate Implicit in the Lease."[9] Such lease payments do not incorporate non-lease items, which typically include common area maintenance charges and variable lease payments that are linked to performance, such as payments based on a percentage of the lessee's sales.

A "right of use" (ROU) asset is established that reflects the value of being able to use the leased property.[10] The value of this asset is determined by computing the sum of the lease liability, any lease payments made before the property is available for use by the lessee, and the lessee's direct costs of obtaining the lease.[11] Once the ROU asset is recorded on the lessee's balance sheet, it is amortized on a straight-line basis over the lease term, which is the non-cancellable period of the lease, together with all the following periods covered by an option: the period(s) during which (a) the lease can be extended if the lessee is reasonably certain to exercise that option, (b) the lessee can terminate the lease if the lessee is reasonably certain not to exercise that option, and (c) the lessor can either extend (or not terminate) the lease in which exercise of the option is controlled by the lessor.[12]

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[8] ASU 2016-02, *supra* note 2, at 7.
[9] ASC 842-20-15-1. "Rate Implicit in the Lease" is "the rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred initial direct costs of the lessor." ASC 842-20-15-1, Glossary.
[10] ASC 842-20-30-1.
[11] ASC 842-20-30-5. There is an exception for short-term leases that do not contain a purchase option and whose duration is 12 months or less. Short-term leases generally do not need to be reflected on the lessee's balance sheet if the lessee so elects. ASC 842-20-25-2.
[12] ASC 842-10-30-1.

The lease payments are considered repayments of the lease obligation liability. Because the lease obligation is initially established as the net present value of all lease payments, each individual lease payment has a cost of money component that is recorded as interest expense. Thus, under ASC 842, the expense related to the use of the leased asset for a particular period is the sum of the amortization of the ROU asset, plus the portion of the lease payment that is attributed to interest expense for that period. As illustrated in Example I (at the end of this article), this increases the GAAP occupancy expense relative to the actual lease payments in the early years of the lease, with the opposite occurring in the later years. This is a departure from FAS 13, which essentially requires the lessee to divide the total amount of lease payments by the number of monthly lease payments to determine the monthly lease cost.[13]

B. *Tax Principles*

The Internal Revenue Code (the Code) affords greater flexibility than GAAP in accounting for lease payments. The structure of the lease arrangement, however, may mandate certain accounting methods.

i. Cash Method Lessees

A cash basis taxpayer generally can deduct lease payments when paid. Regulation § 1.461-1(a) limits the deductibility of prepaid rent where the expenditure results in the creation of an asset that has a useful life that extends substantially beyond the close of the taxable year of payment. In such cases, the deductible lease payments are limited to rent applicable to the year of payment, and nondeductible rent payments are generally capitalized and deducted in the subsequent period(s) to which the rent relates.[14] Prepayments of rent prior to the commencement of the lease term are not deductible until the lease term actually begins.[15]

In *Zaninovich v. Commissioner*,[16] the Ninth Circuit Court of Appeals considered the deductibility of prepaid rent where the lessee was required to make an advance payment of rent for the first 12 months of the lease. The lease had a term of 20 years and 11/12ths of the advance payment was for rent for the taxable year subsequent to the year of payment. The court held that the prepayment of one year’s rent was not substantially beyond the close of the taxable year of payment, and therefore all the prepaid rent was deductible in the year of payment.

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[13] FAS 13, *supra* note 1, ¶ 15.
[14] In *Smith v. Commissioner* (51 T.C. 429 (1968)), a portion of the rental payments were attributed to the cost of a purchase option rather than rent. In *Baton Coal Co. v. Commissioner* (51 F.2d 469 (3d Cir. 1931)), the taxpayer made a bonus rental payment that the courts determined was an advance rental payment that had to be capitalized and amortized over the remaining lease term.
[15] Sorrel v. Comm’r, 882 F.2d 484 (11th Cir. 1989).
[16] 616 F.2d 429 (9th Cir. 1980).

ii. Accrual Method Lessees

Most issuers of GAAP financial statements are accrual method taxpayers. An accrual basis taxpayer cannot deduct an expense until economic performance occurs.[17] If the liability of a taxpayer arises out of another party providing services or property to the taxpayer, economic performance occurs as the services or property are provided.[18] The amount of the deduction is measured by the amount of the taxpayer's liability arising from the provision of such services or property. Therefore, an accrual method taxpayer generally deducts the rent during the period in which the rent accrues under the lease, regardless of when paid. There is an exception to the general rule if an accrual method taxpayer leases property from a related party who uses the cash method of accounting. In such situations, § 267(a)(2) defers the deduction for rent owed to the related party lessor until the time when the related party includes the rent payment in income.[19]

If a lease does not provide for varying payments, the GAAP accounting treatment under FAS 13 and the tax treatment for an accrual basis lessee are generally identical. That is generally no longer the case under ASC 842. Example I illustrates the tax and accounting differences under a 60-month lease with monthly payments of $10,000. For tax purposes, the lessee deducts $10,000 monthly over the lease term, while under ASC 842, the monthly amortization of the ROU asset and the monthly imputed interest on the lease liability exceeds $10,000 in the early months of the lease and is less than $10,000 in the later months of the lease. Consequently, for taxpayers who have adopted ASC 842, a new temporary book-tax difference must be reported in Schedule M-1 (or Schedule M-3 in the case of large taxpayers) of the taxpayer's return.

Preparing an analysis similar to that presented in Example I may be helpful when a practitioner is calculating the amount of a book-tax difference. From a practical perspective, identifying the components of occupancy cost can be tedious, because, as shown in Example I, GAAP occupancy expenses are broken down into two categories: rent and interest expense.

If the lease provides for varying lease payments throughout the lease term, the tax accounting rules become more complicated for accrual method lessees. Under the general rules set forth in Regulation § 1.461-4, the rents are deductible as they become due under the lease. However, for GAAP purposes under FAS 13, the rents will be leveled, and a constant rental amount will be charged each month. Similarly, under ASC 842, the ROU asset is amortized on a straight-line basis. Therefore, irrespective of which accounting regime the taxpayer employs for GAAP purposes, there will be a temporary book-tax difference that must be reported on Schedule M-1/M-3.

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[17] Treas. Reg. § 1.461-4.
[18] Treas. Reg. § 1.461-4(d)(2).
[19] *See* § 267(b) for relationships requiring such matching.

If a lessee incurs lease acquisition costs, such costs are generally capitalized for tax purposes and are amortized on a straight-line basis over the lease term.[20] The amortization is typically shown on the tax return as a separate deduction and not included in rent expense. Such costs are also capitalized under ASC 842 but are embedded in the ROU asset. Therefore, when reporting a temporary difference on Schedule M-1/M-3, care should be taken to ensure that lease acquisition costs are not omitted or double counted.

The following table summarizes the GAAP and tax accounting methods available to a lessee who incurs rent expense under an operating lease:

FAS 13	**ASC 842**	**TAX-CASH BASIS METHOD**	**TAX-ACCRUAL METHOD**
Straight-line rent (divide total rental payments by number of months to determine monthly rent)	Amortize ROU asset using straight-line method, add imputed interest expense on lease liability	Deduct rent payments when made, unless benefit of payment extends substantially beyond the year of payment	Deduct rent as economic performance occurs

II. LESSOR ACCOUNTING

A. *ASC 842*

FAS 13 sets forth the fundamental regime for operating leases which is, in large measure, retained by ASC 842. Under FAS 13 and ASC 842, the form of operating lease reporting is similar to tax reporting.[21] The lessor is treated as the owner of the property and reports payments from the lessee as rent. FAS 13 summarizes the accounting treatment as follows:

> Rent shall be reported as income over the lease term as it becomes receivable according to the provisions of the lease. However, if the rentals vary from a straight-line basis, the income shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit from the leased property is diminished, in which case that basis shall be used.[22]

[20] Treas. Reg. § 1.162-11(a).
[21] FAS 13, *supra* note 1, at 14.
[22] *Id.* ¶ 19b.

ASC 842 follows this rationale:

> Generally, during the lease term a lessor shall recognize the lease payments as income in profit or loss over the lease term on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the underlying asset.[23]

B. *Tax Principles*

A cash basis lessor generally reports lease payments as income when received. An accrual basis lessor generally includes lease payments in income upon the earlier of the period of accrual or receipt.[24] The TCJA modified § 451(b) to provide that certain accrual method taxpayers must include an item in gross income no later than when it is taken into account as revenue for financial statement purposes.[25] This rule is limited to taxpayers who issue "applicable financial statements," which are those that are certified as prepared in accordance with U.S. GAAP or international financial reporting standards and are either (a) filed with the SEC or a foreign equivalent, (b) an audited financial statement used for credit purposes or reporting to owners, or (c) prepared for any other substantial non-tax purpose.[26]

Section 451(b) does not apply to any item of gross income for which the taxpayer uses a special method of accounting, which includes methods of accounting for certain rental payments under § 467.[27] Therefore, from a lessor's perspective, gross income from payments received under a § 467 lease is not subject to acceleration under § 451(b). As noted below, each lease must be separately analyzed to determine whether it is a "§ 467 Rental Agreement," which can be a time-consuming endeavor if the lessor has numerous leases.

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[23] ASC 842-30-25-11.
[24] Treas. Reg. § 1.61-8(b). *See* exception provided by § 467, discussed *infra* Part III.
[25] I.R.C. § 451(b)(1)
[26] I.R.C. § 451(b)(3).
[27] I.R.C. § 451(b)(2); Treas. Reg. § 1.451-3(a)(13)(vii). *See infra* discussion Part III.

The following table summarizes the GAAP and tax accounting methods available to a lessor who receives rental income under an operating lease:

FAS 13 & ASC 842	TAX-CASH BASIS	TAX ACCRUAL BASIS	TAXPAYERS SUBJECT TO § 451(b)
Straight-line rent (divide total rental payments by number of months to determine monthly rent)	Include rent payments when received	Include rent payments upon earlier of receipt or period of accrual under lease agreement	Earlier of tax or GAAP recognition

III. SECTION 467 IMPLICATIONS

Section 467 was added to the Code as an attempt to curb perceived abuses associated with certain leasing transactions by requiring the lessor and lessee to report the transaction simultaneously and consistently with one another, irrespective of their overall accounting methods. Leases subject to this section are called "§ 467 Rental Agreements," which are rental agreements for the use of tangible property under which (a) there is at least one amount allocated to the use of property during a calendar year that is to be paid after the close of the calendar year following the year in which such use occurs or (b) there are increases in the amount to be paid as rent under the agreement. [28]

Section 467 Rental Agreements do not include leases where the amounts paid for the use of property are $250,000 or less. Under the authority of § 467(b)(5), certain increases are not considered to be increases under § 467(d)(1)(B), including: (a) increases tied to an objective, verifiable index (e.g., the Consumer Price Index), (b) reasonable rent holidays (a three-month safe harbor is provided), and (c) changes in amounts paid to unrelated third parties (this allows a landlord to increase rents based on increased costs of doing business).

A. *Tax Avoidance Transactions*

A § 467 Rental Agreement can be a "tax avoidance transaction," if it has a principal purpose of tax avoidance and has one of the following attributes:[29] (a) is a disqualified leaseback, which is defined as a lease to any person (or related party) who had an interest in the leased property at any time during the two-year period

[28] I.R.C. § 467(d).
[29] I.R.C. § 467(b)(4).

prior to the lease [30] or (b) is a long-term lease, which is defined as having a term in excess of 75 percent of the leased property's statutory recovery period.[31]

When a § 467 Rental Agreement is a tax avoidance transaction, rents are leveled using a constant rental amount for the duration of the lease.[32] The mechanics of the computation are somewhat similar to that of a lessee under ASC 842, except different interest rates are used.[33] The IRS, rather than the parties to the lease, determines whether tax avoidance is a principal purpose.[34] Therefore, it is potentially problematic for taxpayers seeking rent-leveling to presume that the lease meets the requirements to be treated as a tax avoidance lease.[35] In practice, it is difficult to meet the requirements for tax avoidance without distorting the economic arrangement beyond commercial viability. In the rare instances when those requirements are met, taxpayers generally can structure a lease such that there is a reasonable, but not absolute, certainty that the lease will be treated as a tax avoidance lease.

B. *Accounting for § 467 Rental Agreements*

For § 467 Rental Agreements that are not tax avoidance transactions, rents are generally allocated in accordance with the agreement.[36] Most § 467 Rental Agreements allocate rent to specific periods, but in the unusual situation where rent is not allocated among specific periods, the amount allocated to each period is determined on a level present value basis.[37] If the rental agreement provides for a payment that is deferred beyond the taxable year of use, the deferred payment is treated as a loan from the lessor to the lessee, and interest is imputed on such loan at 110 percent of the applicable federal rate.[38] Both the lessor and lessee are required to account for lease payments under § 467 irrespective of their accounting methods. Therefore, both parties are effectively placed on the accrual method when accounting for lease payments. Because rent is allocated in accordance with the rental agreement, prepaid rent attributable to a § 467 Rental Agreement is not included in the lessor's income, nor is it deductible by the lessee, until the specific period to which it relates. Therefore, a cash basis lessee is not entitled to deduct prepaid rent attributable to a § 467 Rental Agreement, even though the prepayment does not create an asset that extends substantially beyond the year of payment. Consequently, cash basis lessees should determine whether the lease is a § 467 Rental Agreement before prepaying rent when trying to accelerate deductions.

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[30] I.R.C. § 467(e)(2).
[31] The statutory recovery period is the ACRS life in effect for 1984 (i.e., 19 years for real property). I.R.C. § 467(e)(3).
[32] I.R.C. § 467(b)(2).
[33] Treas. Reg. § 1.467-2(d). A detailed discussion of accounting for tax avoidance transactions is beyond the scope of this article.
[34] Treas. Reg. § 1.467-3(b).
[35] The definition of tax avoidance is set forth in Regulation § 1.467-3(c).
[36] I.R.C. § 467(b)(1)(A).
[37] I.R.C. § 467(b)(2).
[38] I.R.C. § 467(b)(1)(B); Treas. Reg. § 1.467-4.

Example II illustrates a more complex situation involving a § 467 Rental Agreement where important details are easily overlooked. Increasing rents over the lease term cause the lease to be a § 467 rental agreement. Lease acquisition costs are another complexity introduced in Example II. From the lessee's perspective, the amortization of lease acquisition costs represents additional GAAP rent expense but are likely separately stated as amortization expense in the tax return. From the lessor's perspective, the lease acquisition cost amortization is netted against GAAP rental income but is likely separately stated as amortization in the tax return. Whenever a practitioner deals with a § 467 Rental Agreement that is subject to either FAS 13 or ASC 842, it is helpful to prepare an analysis similar to that shown in Example II in order to ensure that items, such as lease acquisition costs, are not omitted or duplicated.

C. *Interplay Between §§ 451(b) and 467*

Because § 467 trumps § 451(b), taxpayers who are subject to § 451(b) must identify leases that are § 467 Rental Agreements (that are not also tax avoidance transactions) if those agreements provide for rent during the lease term. Under both FAS 13 and ASC 842, rents are reported on a straight-line basis (i.e., rental revenue is accelerated to earlier years). If the lease is not a § 467 Rental Agreement, the gross income from the lease is not computed using a special method of accounting, and, accordingly, taxable income will be accelerated for taxpayers who are subject to § 451(b). However, if the lease is a § 467 Rental Agreement, the rents will be accounted for under § 467 (a special method) and will not be treated consistently with the straight-line approach set forth in GAAP.

Lessors seeking to manage both GAAP income and taxable income should evaluate the consequences of proposed lease provisions before entering into a lease. It may be possible to achieve financial nirvana by structuring a lease that is subject to rent-leveling for GAAP (thereby accelerating GAAP revenue) but is treated as a § 467 Rental Agreement for tax purposes to avoid the adverse consequences of § 451(b). Taxpayers who entered into § 467 Rental Agreements, but did not properly account for those agreements by reporting them under the general rule of § 61(a)(5), may change their accounting method to properly report rental income from those leases by filing Form 3115.[39]

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[39] Revenue Procedure 2018-31 sets forth the situations when a change of accounting method is an automatic change that does not require IRS approval. Changing accounting methods with respect to leasing transactions is generally automatic only when a lease was misclassified as an operating, sales, or financing lease. Changing the accounting method of an operating lease from the general rule under § 61(a)(5) to § 467 is not an automatic change enumerated in the revenue procedure. Rev. Proc. 2018-31, 2021-35 I.R.B. 1, § 6.03.

CONCLUSION

Properly reporting the tax consequences of lease transactions and planning for them requires an understanding of both GAAP and tax accounting principles. Lessees adopting ASC 842 face an entirely new accounting regime resulting in a change in the methodology employed to account for book-tax differences. If these changes are not properly identified, tax basis occupancy costs may not be properly reported.

From the lessor's perspective, ASC 842 largely retains the existing regime of FAS 13 which includes a straight-line approach that levels rental income over the lease term. However, some lessors may be affected by the changes made to § 451(b), which generally requires simultaneous recognition of rental income when rent-leveling is required under GAAP. Lessors are not subject to § 451(b) if a lease is accounted for using a special method of accounting such as § 467.

Generally, leases with payments exceeding $250,000 that provide for increasing rents are treated as § 467 Rental Agreements. Under such agreements, both the lessor and lessee are effectively placed on the accrual method of accounting and rent is allocated in accordance with the rental agreement. Therefore, lessors who level rents for GAAP may avoid accelerating taxable income under § 451(b). Unfortunately, each lease must be analyzed to determine whether it is a § 467 Rental Agreement, which can be a time-consuming process if a lessor has numerous leases. A practitioner armed with this knowledge can achieve tax savings and properly report lease transactions.

EXAMPLE I

This example demonstrates a relatively simple situation where a lessee leases office space for $10,000 per month for a 60-month term, for total lease payments of $600,000. The lessee does not incur any lease acquisition costs. For purposes of ASC 842, the Rate Implicit in the Lease is 5 percent. The lease is recorded as an operating lease for both GAAP and tax purposes. The net present value of the lease payments using a 5 percent discount rate is $450,509.16. The excess of the total lease payments over the net present value of those payments is $149,490.84 ($600,000 - $450,509.16). To pay off a loan of $450,509.16 over 60 months using a 5 percent interest rate, the monthly payment is $8,501.66.

LESSEE ACCOUNTING

Pursuant to ASC 842-20-30-1, the lessee records a liability of $450,509.16 for GAAP purposes. Since the lessee did not incur any lease acquisition costs and did not make any lease payments before occupying the premises, the ROU asset equals the recorded lease liability.

To determine the occupancy costs under ASC 842-20-30-1, the ROU Asset is amortized on a straight-line basis for a monthly rent expense of $7,508.49. The monthly $10,000 lease payment is treated as a debt service payment on the lease liability with principal and interest components. The total occupancy costs included in expense are the sum of the ROU asset amortization, plus the interest portion of the debt service payment on the lease liability. The chart below shows the monthly expense under ASC 842 for the term of the lease.

If the lessee does not adopt ASC 842, but instead continues to use FAS 13, the lessee does not record an ROU asset and related liability for future lease payments on its balance sheet. It merely records monthly rent expense of $10,000 over the lease term. For tax purposes, the lessee's accounting treatment is dependent upon whether it uses the cash method or accrual method of accounting. Because the lessee issues GAAP-based financial statements, it likely uses the accrual method of accounting for tax purposes and would therefore record monthly rent expense similar to the treatment prescribed by FAS 13.

The right-hand column of the chart shows the monthly temporary GAAP/Tax differences if the Lessee adopts ASC 842.

LESSOR ACCOUNTING

The lessor's accounting treatment is simpler, because, for both GAAP and tax purposes, it reports $10,000 of gross rental income each month.

EXAMPLE I—Summary of Lessee's Accounting

Month	Lease Payment	Amortization of Right to Use Asset	Interest Expense	GAAP Expense	Temporary GAAP/Tax Difference
1	$10,000	$7,508.49	$ 4,711.79	$12,220.28	$2,220.28
2	$10,000	$7,508.49	$ 4,642.51	$12,150.99	$2,150.99
3	$10,000	$7,508.49	$ 4,572.93	$12,081.42	$2,081.42
4	$10,000	$7,508.49	$ 4,503.07	$12,011.55	$2,011.55
5	$10,000	$7,508.49	$ 4,432.91	$11,941.40	$1,941.40
6	$10,000	$7,508.49	$ 4,362.47	$11,870.95	$1,870.95
7	$10,000	$7,508.49	$ 4,291.73	$11,800.21	$1,800.21
8	$10,000	$7,508.49	$ 4,220.69	$11,729.18	$1,729.18
9	$10,000	$7,508.49	$ 4,149.36	$11,657.85	$1,657.85
10	$10,000	$7,508.49	$ 4,077.73	$11,586.22	$1,586.22
11	$10,000	$7,508.49	$ 4,005.81	$11,514.29	$1,514.29
12	$10,000	$7,508.49	$ 3,933.58	$11,442.07	$1,442.07
13	$10,000	$7,508.49	$ 3,861.05	$11,369.54	$1,369.54
14	$10,000	$7,508.49	$ 3,788.22	$11,296.71	$1,296.71
15	$10,000	$7,508.49	$ 3,715.09	$11,223.58	$1,223.58
16	$10,000	$7,508.49	$ 3,641.65	$11,150.14	$1,150.14
17	$10,000	$7,508.49	$ 3,567.91	$11,076.39	$1,076.39
18	$10,000	$7,508.49	$ 3,493.86	$11,002.34	$1,002.34
19	$10,000	$7,508.49	$ 3,419.50	$10,927.98	$927.98
20	$10,000	$7,508.49	$ 3,344.83	$10,853.31	$853.31
21	$10,000	$7,508.49	$ 3,269.85	$10,778.33	$778.33
22	$10,000	$7,508.49	$ 3,194.55	$10,703.04	$703.04
23	$10,000	$7,508.49	$ 3,118.95	$10,627.43	$627.43
24	$10,000	$7,508.49	$ 3,043.03	$10,551.51	$551.51
25	$10,000	$7,508.49	$ 2,966.79	$10,475.27	$475.27
26	$10,000	$7,508.49	$ 2,890.23	$10,398.72	$398.72
27	$10,000	$7,508.49	$ 2,813.36	$10,321.84	$321.84
28	$10,000	$7,508.49	$ 2,736.16	$10,244.65	$244.65
29	$10,000	$7,508.49	$ 2,658.65	$10,167.13	$167.13
30	$10,000	$7,508.49	$ 2,580.81	$10,089.29	$89.29
31	$10,000	$7,508.49	$ 2,502.64	$10,011.13	$11.13
32	$10,000	$7,508.49	$ 2,424.15	$9,932.64	($67.36)
33	$10,000	$7,508.49	$ 2,345.34	$9,853.82	($146.18)
34	$10,000	$7,508.49	$ 2,266.19	$9,774.68	($225.32)
35	$10,000	$7,508.49	$ 2,186.72	$9,695.20	($304.80)
36	$10,000	$7,508.49	$ 2,106.91	$9,615.40	($384.60)
37	$10,000	$7,508.49	$ 2,026.77	$9,535.26	($464.74)
38	$10,000	$7,508.49	$ 1,946.30	$9,454.79	($545.21)
39	$10,000	$7,508.49	$ 1,865.49	$9,373.98	($626.02)
40	$10,000	$7,508.49	$ 1,784.35	$9,292.83	($707.17)
41	$10,000	$7,508.49	$ 1,702.86	$9,211.35	($788.65)
42	$10,000	$7,508.49	$ 1,621.04	$9,129.53	($870.47)
43	$10,000	$7,508.49	$ 1,538.88	$9,047.37	($952.63)
44	$10,000	$7,508.49	$ 1,456.37	$8,964.86	($1,035.14)
45	$10,000	$7,508.49	$ 1,373.53	$8,882.01	($1,117.99)
46	$10,000	$7,508.49	$ 1,290.33	$8,798.82	($1,201.18)
47	$10,000	$7,508.49	$ 1,206.79	$8,715.28	($1,284.72)
48	$10,000	$7,508.49	$ 1,122.90	$8,631.39	($1,368.61)
49	$10,000	$7,508.49	$ 1,038.66	$8,547.15	($1,452.85)
50	$10,000	$7,508.49	$ 954.07	$8,462.56	($1,537.44)
51	$10,000	$7,508.49	$ 869.13	$8,377.62	($1,622.38)
52	$10,000	$7,508.49	$ 783.84	$8,292.32	($1,707.68)
53	$10,000	$7,508.49	$ 698.18	$8,206.67	($1,793.33)
54	$10,000	$7,508.49	$ 612.18	$8,120.66	($1,879.34)
55	$10,000	$7,508.49	$ 525.81	$8,034.30	($1,965.70)
56	$10,000	$7,508.49	$ 439.08	$7,947.57	($2,052.43)
57	$10,000	$7,508.49	$ 351.99	$7,860.48	($2,139.52)
58	$10,000	$7,508.49	$ 264.54	$7,773.03	($2,226.97)
59	$10,000	$7,508.49	$ 176.73	$7,685.22	($2,314.78)
60	$10,000	$7,508.49	$ -	$7,508.49	($2,491.51)
TOTAL	$600,000	$ 450,509.16	$ 149,490.84	$ 600,000.00	$ (0.00)

EXAMPLE II

This example is more complex than Example I and illustrates some of the nuances that are commonly faced by tax practitioners. The lessee leases office space for 60 months. For the first 24 months, the rent is $10,000 per month and is $12,000 per month thereafter, for total payments under the lease of $672,000. The lessee incurs lease acquisition costs of $9,000. The Rate Implicit in the Lease is 5 percent. The lease is recorded as an operating lease for both GAAP and tax purposes. The lessor incurs lease acquisition costs of $6,000.
The net present value of the lease payments using a 5 percent discount rate is $495,023.20. The excess of the total lease payments over the net present value of those payments is $176,976.80 ($672,000 - $495,023.20). To pay off a loan of $495,023.20 over 60 months using a 5 percent interest rate, the monthly payment is $9,341.70.

LESSEE ACCOUNTING

Pursuant to ASC 842-20-30-1, the lessee records a liability of $495,023.20 for GAAP purposes. Since the lessee incurred lease acquisition costs of $9,000, the ROU asset equals $504,023.20 (the sum of the recorded lease liability, plus the lease acquisition costs).

To determine the occupancy costs under ASC 842-20-30-1, the ROU Asset is amortized on a straight-line basis for a monthly rent expense of $8,400.39. The monthly lease payments are treated as a debt service payment on the lease liability with principal and interest components. The total occupancy costs included in expense are the sum of the ROU asset amortization, plus the interest portion of the debt service payment on the lease liability. The chart on the following page shows the monthly expense under ASC 842 for the term of the lease.

If the lessee does not adopt ASC 842 and instead continues to use FAS 13, the lessee does not record an ROU asset and related liability for future lease payments on its balance sheet. The lessee merely records monthly rent expense of $11,200 over the lease term and amortizes the $9,000 lease acquisition costs over 60 months.

Because the lease meets the requirements to be treated as a § 467 Rental Agreement (i.e., it calls for increasing rent payments and the total rent exceeds $250,000), for tax purposes, the lessee deducts monthly rent expense of $10,000 for the first 24 months and $12,000 for the final 36 months of the lease term. The $9,000 of lease acquisition costs are amortized on a straight-line basis over 60 months.

The right-hand column of the chart shows the lessee’s monthly temporary GAAP/Tax differences when ASC 842 is adopted.

EXAMPLE II—Summary of Lessee Accounting

Month	Lease Payment	Amortization of Right to Use Asset	Interest Expense	Lessee's GAAP Expense	Lessee's Lease Acquistion Cost Amortization	Lessee's Tax Expense	Lessee's Temporary GAAP/Tax Difference
1	$10,000	$8,400.39	$ 2,769.25	$11,169.64	$150.00	$10,150.00	$1,019.64
2	$10,000	$8,400.39	$ 2,736.09	$11,136.48	$150.00	$10,150.00	$986.48
3	$10,000	$8,400.39	$ 2,702.80	$11,103.18	$150.00	$10,150.00	$953.18
4	$10,000	$8,400.39	$ 2,669.36	$11,069.75	$150.00	$10,150.00	$919.75
5	$10,000	$8,400.39	$ 2,635.79	$11,036.17	$150.00	$10,150.00	$886.17
6	$10,000	$8,400.39	$ 2,602.07	$11,002.46	$150.00	$10,150.00	$852.46
7	$10,000	$8,400.39	$ 2,568.22	$10,968.60	$150.00	$10,150.00	$818.60
8	$10,000	$8,400.39	$ 2,534.22	$10,934.61	$150.00	$10,150.00	$784.61
9	$10,000	$8,400.39	$ 2,500.08	$10,900.47	$150.00	$10,150.00	$750.47
10	$10,000	$8,400.39	$ 2,465.80	$10,866.19	$150.00	$10,150.00	$716.19
11	$10,000	$8,400.39	$ 2,431.38	$10,831.76	$150.00	$10,150.00	$681.76
12	$10,000	$8,400.39	$ 2,396.81	$10,797.20	$150.00	$10,150.00	$647.20
13	$10,000	$8,400.39	$ 2,362.10	$10,762.49	$150.00	$10,150.00	$612.49
14	$10,000	$8,400.39	$ 2,327.25	$10,727.63	$150.00	$10,150.00	$577.63
15	$10,000	$8,400.39	$ 2,292.24	$10,692.63	$150.00	$10,150.00	$542.63
16	$10,000	$8,400.39	$ 2,257.10	$10,657.48	$150.00	$10,150.00	$507.48
17	$10,000	$8,400.39	$ 2,221.81	$10,622.19	$150.00	$10,150.00	$472.19
18	$10,000	$8,400.39	$ 2,186.37	$10,586.75	$150.00	$10,150.00	$436.75
19	$10,000	$8,400.39	$ 2,150.78	$10,551.16	$150.00	$10,150.00	$401.16
20	$10,000	$8,400.39	$ 2,115.04	$10,515.43	$150.00	$10,150.00	$365.43
21	$10,000	$8,400.39	$ 2,079.16	$10,479.54	$150.00	$10,150.00	$329.54
22	$10,000	$8,400.39	$ 2,043.12	$10,443.51	$150.00	$10,150.00	$293.51
23	$10,000	$8,400.39	$ 2,006.94	$10,407.33	$150.00	$10,150.00	$257.33
24	$10,000	$8,400.39	$ 1,970.60	$10,370.99	$150.00	$10,150.00	$220.99
25	$12,000	$8,400.39	$ 4,079.59	$12,479.98	$150.00	$12,150.00	$329.98
26	$12,000	$8,400.39	$ 4,042.95	$12,443.34	$150.00	$12,150.00	$293.34
27	$12,000	$8,400.39	$ 4,006.16	$12,406.55	$150.00	$12,150.00	$256.55
28	$12,000	$8,400.39	$ 3,969.22	$12,369.60	$150.00	$12,150.00	$219.60
29	$12,000	$8,400.39	$ 3,932.12	$12,332.51	$150.00	$12,150.00	$182.51
30	$12,000	$8,400.39	$ 3,894.87	$12,295.25	$150.00	$12,150.00	$145.25
31	$12,000	$8,400.39	$ 3,857.46	$12,257.84	$150.00	$12,150.00	$107.84
32	$12,000	$8,400.39	$ 3,819.89	$12,220.28	$150.00	$12,150.00	$70.28
33	$12,000	$8,400.39	$ 3,782.17	$12,182.56	$150.00	$12,150.00	$32.56
34	$12,000	$8,400.39	$ 3,744.30	$12,144.68	$150.00	$12,150.00	($5.32)
35	$12,000	$8,400.39	$ 3,706.26	$12,106.65	$150.00	$12,150.00	($43.35)
36	$12,000	$8,400.39	$ 3,668.07	$12,068.45	$150.00	$12,150.00	($81.55)
37	$12,000	$8,400.39	$ 3,629.71	$12,030.10	$150.00	$12,150.00	($119.90)
38	$12,000	$8,400.39	$ 3,591.20	$11,991.59	$150.00	$12,150.00	($158.41)
39	$12,000	$8,400.39	$ 3,552.53	$11,952.91	$150.00	$12,150.00	($197.09)
40	$12,000	$8,400.39	$ 3,513.69	$11,914.08	$150.00	$12,150.00	($235.92)
41	$12,000	$8,400.39	$ 3,474.69	$11,875.08	$150.00	$12,150.00	($274.92)
42	$12,000	$8,400.39	$ 3,435.54	$11,835.92	$150.00	$12,150.00	($314.08)
43	$12,000	$8,400.39	$ 3,396.21	$11,796.60	$150.00	$12,150.00	($353.40)
44	$12,000	$8,400.39	$ 3,356.73	$11,757.11	$150.00	$12,150.00	($392.89)
45	$12,000	$8,400.39	$ 3,317.08	$11,717.46	$150.00	$12,150.00	($432.54)
46	$12,000	$8,400.39	$ 3,277.26	$11,677.65	$150.00	$12,150.00	($472.35)
47	$12,000	$8,400.39	$ 3,237.28	$11,637.67	$150.00	$12,150.00	($512.33)
48	$12,000	$8,400.39	$ 3,197.13	$11,597.52	$150.00	$12,150.00	($552.48)
49	$12,000	$8,400.39	$ 3,156.82	$11,557.20	$150.00	$12,150.00	($592.80)
50	$12,000	$8,400.39	$ 3,116.33	$11,516.72	$150.00	$12,150.00	($633.28)
51	$12,000	$8,400.39	$ 3,075.68	$11,476.07	$150.00	$12,150.00	($673.93)
52	$12,000	$8,400.39	$ 3,034.86	$11,435.25	$150.00	$12,150.00	($714.75)
53	$12,000	$8,400.39	$ 2,993.87	$11,394.25	$150.00	$12,150.00	($755.75)
54	$12,000	$8,400.39	$ 2,952.70	$11,353.09	$150.00	$12,150.00	($796.91)
55	$12,000	$8,400.39	$ 2,911.37	$11,311.76	$150.00	$12,150.00	($838.24)
56	$12,000	$8,400.39	$ 2,869.86	$11,270.25	$150.00	$12,150.00	($879.75)
57	$12,000	$8,400.39	$ 2,828.19	$11,228.57	$150.00	$12,150.00	($921.43)
58	$12,000	$8,400.39	$ 2,786.33	$11,186.72	$150.00	$12,150.00	($963.28)
59	$12,000	$8,400.39	$ 2,744.32	$11,144.70	$150.00	$12,150.00	($1,005.30)
60	$12,000	$8,400.39	$ -	$8,400.39	$150.00	$12,150.00	($3,749.61)
TOTAL	$672,000	$ 504,023.20	$ 176,976.80	$ 681,000.00	$9,000.00	$681,000.00	$ (0.00)

LESSOR ACCOUNTING

From the lessor's perspective, for GAAP purposes, the lessor reports the rental income on a straight-line basis, which is computed by dividing the total rent payable under the lease by the number of months in the lease term regardless of whether the lessor has adopted ASC 842 or continues to use FAS 13. In this case, that amount is $11,200 ($672,000, divided by 60). The lessor also amortizes the lease acquisition costs of $6,000 over a 60-month period using the straight-line method, resulting in monthly amortization of $100. The net monthly income reported by the lessor is $11,100 ($11,200, minus $100). The treatment is substantively identical whether the lessor uses FAS 13 or ASC 842.

Because the lease meets the requirements to be treated as a § 467 Rental Agreement (i.e., it calls for increasing rent payments and the total rent exceeds $250,000), for tax purposes, the lessor includes monthly gross income of $10,000 for the first 24 months and $12,000 for the final 36 months of the lease term. The $9,000 of lease acquisition costs are amortized on a straight-line basis over 60 months. The amortization expense will be deducted from gross income.

The chart below shows the lessor's monthly temporary GAAP/Tax differences.

EXAMPLE II—Summary of Lessor Accounting

GAAP			TAX			
Lessor GAAP Lease Revenue	**Lessor's Lease Acquistion Cost Amortization**	**Lessor GAAP Lease Net Income**	**Lessor's Tax Gross Income**	**Lessor's Lease Acquistion Cost Amortization**	**Lessor's Taxable Income**	**Lessor's Temporary GAAP/Tax Difference**
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$10,000	$ 100.00	$9,900.00	$1,200.00
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 11,200.00	$ 100.00	$ 11,100.00	$12,000	$ 100.00	$11,900.00	$ (800.00)
$ 672,000.00	$ 6,000.00	$ 666,000.00	$ 672,000.00	$ 6,000.00	$ 666,000.00	$ -