Project **Leases**

Topic **Long Term Leases of Land**

Background and purpose of paper

1. At the joint meeting in February 2010 the boards tentatively decided that very long leases of land would not be considered purchases or sales of the underlying asset. However, the boards instructed the staff to develop possible criteria for excluding very long leases of land from the scope of the proposed new leases requirements.

2. In order to develop these criteria, the staff requested input from the joint leases working group. We also reached out to some national standard-setters in jurisdictions where long term leases of land are common. Comments received are summarised in the appendix to the paper.

3. As a result of feedback received and additional staff analysis, this paper recommends that the boards do not exclude very long leases of land from the scope of the proposed new leases requirements.

4. If, however, the boards continue to think that very long leases of land should be excluded from the scope of the proposed new leases requirements, this paper recommends that they be defined as leases with a minimum possible lease term of 50 years or more that are substantially prepaid and under which the lessor retains no material rights or obligations associated with the land during the term of the lease other than legal title.

5. The staff also recommend that the new leases requirements should specify the required accounting for leases of this type rather than simply exclude them from the scope of the new requirements.

Description of the issue

6. In some jurisdictions it is common for land to be provided by lessors to lessees under very long leases (eg 99 years, 125 years, 999 years). Leases of this type are often substantially prepaid by the lessee and provide the lessor with very few rights during the term of the lease. The price paid by the lessee for leases of this type will usually be similar to the price paid for an out-right purchase. However, the lessor retains legal title to the land. Consequently, the lessor can normally sell the land (subject to the lease) and retains all the benefits associated with the land after the end of the lease.

7. Under the proposed approach to lessee accounting, a lessee who enters into a very long term lease of land will recognise a right-of-use asset and an obligation to pay rentals (if they have not fully prepaid the lease).

8. Under the performance obligation approach to lessor accounting, a lessor who enters into a very long term lease of land will retain the leased land in their financial statements and recognise a performance obligation that will be released to income over the term of the contract (eg 99 years, 125 years or even 999 years).

9. Some view very long term leases of land as economically similar to purchases/sales of the underlying land and consequently, think it is inappropriate to retain the land on the lessor's statement of financial position and spread the proceeds received over the term of the lease. Others disagree and view long term leases of land as similar to other leases because of the lessor's retention of legal title and rights over the land at the end of the lease.

10. This paper deals with accounting for long term leases of land under the PO approach to lessor accounting only. Under a derecognition accounting model for lessors, the lessor would derecognise that portion of the land that is transferred

to the lessor under the long term lease and no performance obligation would be recognised.

Should the boards provide an exemption for very long term leases of land?

11. Some staff think that no exemption should be provided for very long term leases of land because:

    (a) Even very long leases are not sales of the underlying land. The lessor retains title to the land during the lease term. At the end of the lease, the lessor will regain possession of the land which will (presumably) have a significant value. This is consistent with the boards' tentative decision that very long leases of land are not purchases or sales of the underlying land.

    (b) There is no conceptual basis for differentiating very long leases of land from other leases. Any definition of a very long lease will inevitably be arbitrary.

    (c) It is unclear how the lessor's interest in the land would be accounted for at the end of the lease.

12. This view is supported by a number of working group members.

13. Other staff think that long term leases of land are economically similar to purchases/sales of the underlying land. However, they also think that no scope exemption should be provided.

14. These staff note that the proposed lessee accounting model will result in accounting that is very similar to the accounting for an out-right purchase of the underlying asset. The main differences between purchase accounting and lease accounting would be that:

    (a) The lessee will present a right-of-use asset rather than land in its financial statements. (Under IFRS, the lessee would depreciate the land over the lease term whether the transaction was treated as a lease or a purchase. This is because the lessee's interest in the land is a depreciating asset. Under US GAAP, land is not depreciated.)

(b) IFRS preparers who wish to revalue their right to use the land would be required to use the revaluation model in IAS 38 *Intangible Assets* rather than the revaluation model in IAS 16 *Property, Plant and Equipment*. Revaluation under IAS 38 is only permitted if there is an active market in the revalued asset (in practice this is very rare). The staff note that this problem could be resolved if, as suggested by some board members, the IASB permitted lessors to use the IAS 16 revaluation model rather than the IAS 38 model.

15. The staff do not think these differences are significant enough to justify a scope exemption for lessees.

16. The performance obligation approach to lessor accounting is very different from a sale of the underlying land. However, the staff note that:

(a) On the basis of information provided by constituents, very long term leases of land are usually granted by governments, private individuals or trusts. Entities of this type are sometimes required to provide general purpose financial statements in accordance with IFRS or US GAAP. However, in many cases there is no requirement. Consequently, the population affected by this issue is likely to be small.

(b) For IFRS preparers, the lessor's interest in land could be treated as investment property under IAS 40 *Investment Property*. If the fair value model in IAS 40 is used, they will already be excluded from the scope of the new lessor accounting model.

17. Consequently, the staff do not think a scope exclusion should be provided for lessors.

Question for the boards?

Question 1
The staff recommend that very long term leases of land should **not** be excluded from the scope of the new leases requirements for: (a) lessees (b) lessors. Do the boards agree?

18. The rest of this paper is only relevant if the boards disagree with the staff's recommendation in question 1.

Defining very long leases of land

19. Based upon information received from constituents, there is no common understanding of what constitutes a very long lease. In some countries a 30-year lease would be considered very long whilst in others it would be 100 years. In some jurisdictions, long term leases are defined in law (for example, both Hong Kong and Malaysia define long term leases as leases of 50 years or more).

20. Some constituents suggested a more principled approach to defining long term leases of land. For example

    (a) Some suggested that a long term lease of land should be defined as any land lease whose term exceeds the useful life of the leasehold improvements (eg buildings) attached to the land. The staff do not think this approach will work. It is unclear how land that has no leasehold improvements would be treated under this approach. In addition, very short leases could be excluded from the scope if the attached leasehold improvements also have a short useful life.

    (b) Some suggested comparing the present value of the lease payments to the freehold value of the land. If they are substantially the same, the lease would be excluded from the scope of the new requirements. The staff note that this approach would not be operational in jurisdictions where it is not possible to acquire a freehold interest in land (for example, Hong Kong).

21. The staff have been unable to develop a principled approach to defining long term leases of land. Some staff support using a long lease term (eg 99 years) because it would restrict the number of leases that would be treated as very long term. However, in this paper, we recommend that leases with a minimum possible lease term of 50 years or greater should be defined as very long term. This is arbitrary but would seem to capture most of the leases that constituents view as long term.

22. The staff think that simply defining long term leases as leases with a minimum possible lease term of 50 years or more will not be sufficient to capture only those leases that could be viewed as economically similar to sales of the land. As noted by some board members, if the lessor has significant continuing involvement in the land during the term of the lease, accounting for the transaction as a sale/purchase of the land would not reflect the economics of the transaction.

23. Consequently, the staff think that the following additional conditions should be applied:

    (a) The lease is substantially prepaid. If the lease is substantially prepaid, there is little prospect of the lessee losing its right to use the land (or the lessor regaining the right to use the land) because of a failure of the lessee to pay rentals.

    (b) The lessor retains no material rights or obligations associated with the land during the term of the lease other than legal title. This ensures that the lessor's continuing involvement in the land is restricted to its ability to sell the land (subject to the lease) during the lease term and its interest in the land at the end of the lease.

Question for the boards?

Question 2
The staff recommend that very long term leases of land should be defined as leases with a minimum possible lease term of 50 years or more that are substantially prepaid and under which the lessor retains no material rights or obligations associated with the land during the lease term other than legal title Do the boards agree? If you disagree what alternative definition would you support?

Accounting for long term leases of land

24. A number of constituents expressed concern that simply excluding long term leases of land from the scope of the new leases requirements would result in confusion regarding how to account for these leases.

25. One solution to this concern would be to specify the required accounting for very long term leases of land in the proposed new leases requirements.

26. If the boards would like to pursue this approach, the staff recommend the following requirements:

    (a) A lessee should treat a long term lease of land as a purchase of land. The land should be presented together with land that is owned outright. However, the fact that it is held on a long term lease should be disclosed in the financial statements. The land should be depreciated over the term of the lease[1]. The lessee would be permitted to revalue land held under a long term lease in accordance with IAS 16 (IFRS preparers only).

    (b) A lessor should treat a long term lease of land as a sale of the underlying land. The lessor would recognise revenue equal to the fair

[1] Some staff do not support the idea of depreciating land because they view it as inconsistent with US GAAP. Other staff note that depreciating a leasehold interest in land is consistent with the concept of depreciation.

value of the proceeds received. The lessor would derecognise its interest in the land and recognise an asset representing the present value of its interest in the land at the end of the lease. The fact that the lessor has treated a long term lease of land as a sale would be disclosed.

Questions for the boards

Question 3
Do the boards think the new leases requirements should specify the required accounting for long term leases of land?

Question 4
The staff recommend that very long term leases of land should be accounted for as follows: (a) A lessee should treat a long term lease of land as a purchase of land. The land should be presented together with land that is owned outright. However, the fact that it is held on a long term lease should be disclosed in the financial statements. The land should be depreciated over the term of the lease. The lessee would be permitted to revalue land held under a long term lease in accordance with IAS 16 (IFRS preparers only). (b) A lessor should treat a long term lease of land as a sale of the underlying land. The lessor would recognise revenue equal to the fair value of the proceeds received. The lessor would derecognise its interest in the land and recognise an asset representing the present value of its interest in the land at the end of the lease. The fact that the lessor has treated a long term lease of land as a sale would be disclosed. Do the boards agree? If you disagree what alternative approach would you support?

Appendix - Summary of comments from constituents

A1. As part of the research for this paper, the staff requested input from the joint leases working group. We also reached out to some national standard-setters in jurisdictions where long term leases of land are common. This appendix summarises the comments received.

How common are long term leases of land?

A2. Long term leases of land are common in some jurisdictions particularly where land is in short supply (eg Hong Kong, the UK). In other jurisdictions long term leases of land are less common. Although long term leases of land are unusual in the US, they do exist (for example, in the hotel industry).

A3. Long term leases of land are normally granted by governments, trusts, private individuals or charities.

Should there be an exemption for long term leases of land?

A4. Some constituents supported having a scope exemption for long term leases of land because they believed that a very long term lease of land was economically similar to an outright sale. However, many of those who responded to our request for information, did not support excluding long term leases because:

(a) A long term lease of land is not a sale of the underlying land (the lessor retains legal title and an interest in the land at the end of the lease).

(b) Derecognising land that is subject to a very long term lease is inconsistent with the performance obligation approach to lessor accounting (unless the contract is a sale rather than a lease).

(c) Any definition of what constitutes a long term lease of land would be arbitrary.

A5. Some constituents also noted that the proposed lessee accounting model will result in accounting that is very similar to the accounting for an out-right purchase of the underlying asset. Consequently, they questioned whether a scope exclusion was necessary for lessees.

A6. Some constituents expressed concern that simply excluding long term leases of land from the scope of the new leases requirements would result in confusion regarding how to account for these leases.

How should long term leases of land be defined?

A7. What is considered a long term lease varies from country to country. In some countries a 30-year lease would be considered very long whilst in others it would be 100 years. In some jurisdictions, long term leases are defined in law (for example, both Hong Kong and Malaysia define long term leases as leases of 50 years or more).

A8. Some constituents suggested that long term leases of land should be defined in a more principled way:

(a) Some suggested that a long term lease of land should be defined as any land lease whose term exceeds the useful life of the leasehold improvements (eg buildings) attached to the land.

(b) Some suggested comparing the present value of the lease payments to the freehold value of the land. If they are substantially the same, the lease would be excluded from the scope of the new requirements.

Lessor accounting model

A9. Some constituents noted that the problems associated with long term leases of land arise because of the board's decision to adopt the performance obligation approach to lessor accounting. They noted that this problem would not exist under a derecognition approach to lessor accounting.