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September 5, 2003

General Services Administration
FAR Secretariat (MVA)
Attention: Ms. Laurie Duarte
Room 4035
1800 F Street, N.W.
Washington, D.C. 20405

**Re: FAR Case 2002-008;
Proposed Rule: Gains and Losses (FAR 31.205-16);
68 Fed. Reg. 40466, July 7, 2003**

Dear Ms. Duarte:

On behalf of the Section of Public Contract Law of the American Bar Association ("the Section"), I am submitting comments on the above-referenced matter. The Section consists of attorneys and associated professionals in private practice, industry, and government service. The Section's governing Council and substantive committees contain members representing these three segments to ensure that all points of view are considered. In this manner, the Section seeks to improve the process of public contracting for needed supplies, services, and public works.

The Section is authorized to submit comments on acquisition regulations under special authority granted by the Association's Board of Governors. The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association.

Introduction

FAR Case 2002-008 proposes to amend FAR 31.205-16, "Gains and losses on disposition or impairment of depreciable property or other capital assets," by adding a rule addressing how and when a gain or loss is determined in a sale and leaseback transaction. The proposal would define the date of disposition in such a transaction to

be the *later* of “[t]he latest ending date of the lease term, including any extensions and renewals” or “[t]he date the contractor vacates the property.” In addition, the proposal specifies that the “adjusted asset value” at time of disposition for purposes of computing gain or loss is the original asset acquisition cost, less allowable depreciation costs up to the date of the sale and leaseback, *and* less the depreciation costs that would have been allowed had the contractor retained title up to the time of “disposition” as defined in the proposal. *See* 68 Fed. Reg. 40467.

Background

Since 1959, the rental cost principle (currently FAR 31.205-36) has provided that rental costs under a sale and leaseback arrangement are allowable only up to the amount that would be allowed if the contractor had retained title (“ownership costs”). *See* FAR 31.205-36(b)(2). In 1959, and for 10 years thereafter, the cost principles provided that neither gains nor losses arising from the sale or exchange of plant, equipment, or other assets were to be considered in computing contract costs. *See, e.g.,* ASPR 15-205.32; FPR 1-15.205-32.

In 1969, the ASPR Committee published Revision No. 4 to ASPR 15-205.32. For the first time, gains and losses on the disposition of certain depreciable assets were to be taken into account in computing contract costs. This major change in policy was driven by the conviction that contractors employing new accelerated depreciation rules were enjoying huge gains upon disposing of depreciable assets. The regulators felt that, if the government was footing the bill for higher depreciation costs, it should also share in the larger gains made possible by the accelerated depreciation. The primary debate was whether the government should share in all gains (and, to be fair, losses) without limitation, or whether its share of the gain should be limited to the amount of depreciation charged to the government by the contractor.

The final draft of the rule sent to the Assistant Secretary of Defense (Installation and Logistics) for approval in November of 1968 took the approach that the government should share in all gains and losses on disposition of depreciable property regardless of the depreciation charge to the government on such assets. The cover memorandum accompanying the draft rule candidly acknowledged that industry generally opposed the proposal. *See* Memorandum for Mr. Morris, 14 Nov. 1968.* In response to a CODSIA comment, this final draft contained a provision in subparagraph (e) explicitly addressing sale and leaseback arrangements:

*Historical documents cited are in the files of ASPR Case 65-107 received in response to FOIA requests.

(e) Gains or losses resulting from the sale of property which is leased back shall not be recognized where the resulting rental costs are limited to those of ownership under 15-205.34(c) or 15-205.48(b)(3).

In its memorandum to the full ASPR Committee dated October 7, 1978, the Part 2, Section XV Subcommittee explained that:

A new subparagraph (e) has been added to state that gains and losses resulting from assets which are sold and leased back shall not be recognized where the Government allows only costs of ownership after the transaction. The Subcommittee agrees with CODSIA that it would be inequitable to recognize gains and losses under these circumstances.

The Assistant Secretary of Defense subsequently determined that, as a policy matter, he could not support the approach of sharing "all gains and losses," and he directed the ASPR Committee to reinstate the prior version of the rule which took the "depreciation recapture" approach. *See* ASPR Committee Minutes, April 23, 1969. The previous draft, dated 26 February 1968, became the final rule on August 29, 1969. Because the previous draft did not include the separate paragraph on sale and leaseback arrangements, this provision did not become part of the final rule.

The Defense Contract Audit Agency ("DCAA") Contract Audit Manual ("CAM") has for quite some time taken the position that:

A gain from the sale of a depreciable asset that is simultaneously leased back under the type of arrangement covered by FAR 31.205-36(b)(2) should not be recognized as a credit to overhead in the year in which the arrangement was transacted. * * * If, at the time of actual disposition of the leased asset, there continues to be a gain or loss associated with the asset, this gain or loss should be recognized.

DCAA CAM ¶ 7-208. It is apparent that DCAA's longstanding position on the appropriate treatment of gains and losses in the context of sale and leaseback arrangements is reflected in the proposed rule.

DCAA explained its position in a letter dated October 18, 1993 from Michael Thibault to Ron Solomon of HHS. DCAA's position, Mr. Thibault explained, was

based on its conclusion that the FAR 31.205-16 requirement to recognize gains and losses from “sale, retirement, or other disposition” of depreciable property *in the year in which they occur* does not apply to sale and leaseback arrangements (emphasis added). DCAA concluded that a sale and leaseback arrangement is not a “sale” for purposes of FAR 31.205-16 based on its conclusion that the term “sale and leaseback arrangement” as used in FAR 31.205-36(b)(2) refers to a single transaction which is neither a “sale” nor a “lease.” DCAA further concluded that a sale and leaseback transaction is not an “other disposition” based on language from the February 26, 1968 subcommittee report (ASPR Case 65-107), in which the subcommittee stated that it added the category of “other dispositions” to “cover such situations as trade-ins or abandonments in place,” which would not be covered by the original reference to “sale or retirement” of the property.

To further support its conclusion that a sale and leaseback is not an “other disposition” under 31.205-16, DCAA cited the ASPR subcommittee’s conclusion that

Gains and losses resulting from assets which are sold and leased back shall not be recognized where the Government allows only costs of ownership after the transaction. The Subcommittee agrees with CODSIA that it would be inequitable to recognize gains and losses under these circumstances.

DCAA goes on to state in its 1993 letter:

Thus, while the cost principle language does not explicitly exclude the recognition of gains and losses under a sale and leaseback arrangement, the intent of the drafters was clearly established during the deliberations of this cost principle coverage.

Discussion

The proposed change to FAR 31.205-16 would defer recognition of gain or loss on depreciable property in the case of a sale and leaseback arrangement until the later of: (1) termination of the lease; or (2) the date the contractor vacates the property. The rule would measure the contractor’s gain or loss as the difference between the fair market value of the property at that time and the “adjusted asset value,” defined as the contractor’s original asset cost, minus allowable depreciation costs for the period prior to the sale and leaseback, *and* minus the depreciation costs that would have been allowed had the contractor retained title. Unlike the treatment accorded the simple sale of an asset under subparagraph (c) of the cost principle,

recognition of gain would not be limited to recapture of depreciation. Rather, the proposal would allow the government to recover a share of market-driven increases in the value of the property occurring both before and after the sale and leaseback transaction, or even increases due to subsequent improvements by the new owner.

The proposed change is also in conflict with the CAS 409 requirement that expressly limits gain recognition to the difference between the original acquisition cost of the asset and its undepreciated balance when there is gain on disposition. By recognizing the full amount of market-driven gain (as well as gain from other causes), and by imputing continued "depreciation" on the asset after it is no longer owned by the contractor, the proposal violates this CAS 409 requirement.

Why there should be such a dramatic difference in treatment of gains and losses due to sales and those due to sale and leaseback arrangements is not explained anywhere in the proposal. Nor does the proposal explain why *any* gain or loss should be recognized in sale and leaseback arrangements. The drafters of the rule recognized in 1968 that it would be inequitable to recognize gains and losses where the government allows only costs of ownership after the transaction. The proposal fails to address this point at all, a failure that is particularly troubling in light of DCAA's acknowledgement that the clear intent of the drafters was not to recognize such gains and losses. We fail to see any change in circumstances that would undo or mitigate the inequity acknowledged by the drafters in 1968.

The only statement of rationale for the proposed change appears in the preamble to the proposal: "[T]he Government would be precluded from recovering the financing costs that were imbedded in the sales price should the gain be recognized at the date of the sale and leaseback arrangement." See 68 Fed. Reg. 40466. This statement addresses the reason the proposal defers recognition until a later date, but does not address the issue of whether it is equitable to recognize gain or loss at all when the subsequent lease costs are limited to costs of ownership. Moreover, the rationale as stated is somewhat cryptic, to say the least, and leaves the reader wondering exactly what it is that the government would be giving up, that it otherwise would be entitled to, if gain and loss were to be recognized at the time of entering into the transaction. If the comment refers to the possibility that the sales price could be artificially low, in return for lower than market rents for a period of years, it would seem that a rule could be targeted more directly at the understated selling price.

For the foregoing reasons, the Section recommends that, if the proposal is not withdrawn, it be republished as a proposed rule and that the discussion accompanying the proposal address the following three fundamental issues:

1. In light of the FAR 31.205-36(b)(2) limitation of lease costs in a sale and leaseback arrangement to the costs of ownership, why is it equitable for any gain or loss to be recognized in connection with the transaction?

2. Assuming the equity of recognizing gain or loss in connection with a sale and leaseback arrangement can be demonstrated, what reason is there that such gain or loss cannot be recognized at the time of the transaction, perhaps with an appropriate adjustment if the sales price and the subsequent rental cost are both below market?

3. In any event, what justification is there for not limiting the amount of gain to be recognized by the amount of depreciation taken?

The Section appreciates the opportunity to provide these comments and is available to provide additional information or assistance as you may require.

Sincerely,



Hubert J. Bell, Jr.

Chair

Section of Public Contract Law

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