Sale-Leaseback Discussion

What is a sale-leaseback?

In its most common form, the corporate owner/occupant of a building sells its building and then leases it back. The owner/occupant converts its investment in real estate into cash, and then gets certain accounting and tax treatment benefits.

A high visibility example of a sales-leaseback is the recent sale by the New York Times Company of its 52 story headquarters building on 8th Avenue in NYC. As a financially challenged newspaper publisher, the Times was looking for a way to raise cash. It was able to raise $225MM by selling the portion of the building it occupied to an investment firm and leasing that portion back for 15 years.

Why does the Seller/Tenant want to pull its money out of its real estate? Because it believes that it will earn a higher rate of return by investing in its core business, about which it knows a lot, then it will in real estate, about which it knows less.

A major benefit of a sale-leaseback derives from the financial accounting treatment and tax treatment of a sale-leaseback. A properly structured sale-leaseback receives off balance sheet treatment for accounting purposes, and rent payments are fully deductible from income for tax purposes. Of course, that only happens if the transaction is properly structured, meaning that the Buyer/Landlord must be deemed the owner of the property for both tax and financial accounting purposes. It is very important that the attorney work closely with the client's accountant in structuring the transaction.

Structure of Transaction.

Often triple net "bondable" lease with a credit tenant.

Lease term usually 20 + years.

Often significant value to the remainder interest.

What are the benefits of a Sale-Leaseback?

The Seller/Tenant frees up money invested in the property by selling the asset and yet retains substantially the same level of control.

If the lease is properly structured as an operating rather than a capital lease, the lease is an off-balance sheet transaction. Because the property is not shown as an asset, the Seller/Tenant's return on assets is higher. Because debt on the property does not show up as a liability on the Seller/Tenant's balance sheet, it no longer affects debt covenant ratios.

Monthly installments of rent are fully deductible; if the Seller/Tenant instead obtained a mortgage loan, only the interest component of debt service would be deductible.

The Seller/Tenant typically retains operational control over the property, as the Seller/Landlord is typically a passive investor.

The Buyer/Landlord receives a secure income stream for the term of the lease with no operational responsibility. Akin to a bond but with a higher return. Buyer/Landlord gets the upside on reuse of the property after expiration of the lease.

Buyer/Landlord gets to deduct depreciation from its taxes.

Financial Accounting Issues

Off balance sheet treatment requires classification of the lease as an operating rather than a capital lease. Financial Accounting Standards Board Statement 13 determines whether a lease is operating or capital.

For lessees, a lease is a capital lease if it meets any one of four conditions; if not, it is an operating lease. A capital lease is treated as the acquisition of an asset and the incurrence of a liability by the lessee. Operating leases are treated as current operating expenses.

Operating versus Capital Leases

In an operating lease, the landlord transfers to the tenant only the right to use the property, and at the end of the lease term, the tenant surrenders the property to the landlord. The tenant does not assume the risk of ownership, and so the lease expense is treated as an operating expense in the income statement and the lease does not affect the tenant's balance sheet. In a capital lease, the tenant assumes some of the risks of ownership and enjoys some of the benefits. Consequently, the lease, when signed, is recognized both as an asset and as a liability (for the lease payments) on the balance sheet. The tenant gets to claim depreciation each year on the asset and also deducts the interest expense component of the lease payment each year. In general, capital leases recognize expenses sooner than equivalent operating leases.

Firms generally prefer to keep leases off their books and often prefer to defer expenses. Accordingly, firms generally prefer to characterize their leases as operating leases. The Financial Accounting Standards Board has ruled that a lease should be treated as an capital lease if it meets any one of the following four conditions:

(a) if the lease life exceeds 75% of the life of the asset;
(b) if there is a transfer of ownership to the lessee at the end of the lease term;
(c) if there is an option to purchase the asset at a "bargain price" at the end of the lease term; or
(d) if the present value of the lease payments, discounted at an appropriate discount rate, exceeds 90% of the fair market value of the asset.

The landlord uses the same criteria for determining whether the lease is a capital or operating lease and accounts for it accordingly. If it is a capital lease, the landlord records the present value of future cash flows as revenue and recognizes expenses. The lease receivable is also shown as an asset on the balance sheet, and the interest revenue is recognized over the term of the lease, as paid. From a tax standpoint, the landlord can claim the tax benefits of the leased asset only if it is an operating lease, though the revenue code uses slightly different criteria for determining whether the lease is an operating lease.

When a lease is classified as an operating lease, the rent is treated as operating expense and the operating lease does not show up as part of the capital of the tenant. When a lease is classified as a capital lease, the present value of the lease expenses is treated as debt, and interest is imputed on this amount and shown as part of the tenant's income statement. In practical terms, however, reclassifying operating leases as capital leases can increase the debt shown on the balance sheet substantially, especially for firms in sectors which have significant operating leases (e.g., airlines and retail firms).

SFAS 98 prohibits "continuing involvement" in the property by Seller/Tenant. Continuing involvement includes:

1. The obligation or fixed price option to acquire the property;
2. Being obligated to compensate Buyer/Landlord for any decline in the value of the property at lease expiration.

Tax Treatment

If the sale-leaseback structure is respected for tax purposes, the sale of the property to Buyer/Landlord will be recognized as a bona fide sale and the Buyer/Landlord will recognize rental income under the lease and claim deductions for depreciation and interest expense on the acquisition loan. The Seller/Tenant will deduct rental expense from its taxable income. If however, the transaction is recharacterized as a financing, the "sale" will be deemed a loan from the Buyer/Landlord to the Seller/Tenant, and the Buyer/Landlord will recognize interest income on the "loan" to Seller/Tenant. The Seller/Tenant will not be permitted to deduct rent from it taxable income, but will be able to continue to deduct depreciation as well as the "interest" component of its rent payments.