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Financing Focus

Sale-Leasebacks Provide Capital for Core Business Investment

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The market for sale-leasebacks — transactions in which companies sell and then lease back real estate assets — is growing at an estimated $10 billion to $15 billion annually. Continued increases are expected due to today`s difficult real estate financing environment, which is characterized by a weak stock market, lender caution, and strict credit requirements.

Sale-leasebacks allow companies to unlock their real estate assets` equity, raise capital to reduce debt or invest in their core business, and strengthen their balance sheets.

Companies and investors increasingly use sale-leasebacks in Internal Revenue Code Section 1031 exchanges, as well as to trigger gains to utilize expiring net operating losses.

In addition, sale-leasebacks offer an alternative to synthetic leases, which are less favorable today due to the Financial Accounting Standards Board`s recent adoption of Financial Interpretation Number 46. These guidelines provide more-strict rules for off-balance-sheet accounting methods, such as synthetic leases.

Rules and Regulations

When structuring sale-leaseback transactions, companies complying with FASB`s generally accepted accounting principles, or GAAP, must follow FASB Statement 66, Accounting for Sales of Real Estate, which includes rules for recognizing property sales profits.

Depending on the circumstances, this rule may limit or prevent sales or profit recognition. For example, if the seller/lessee acquires an option to purchase the property at a discounted price or subleases more than 10 percent of the property`s value, it would violate the continuing involvement rules under FASB Statement 66 and, therefore, preclude sale treatment under GAAP.

Furthermore, a company must account for the gain from the sale and related leaseback in accordance with FASB Statement 13, Accounting for Leases, and Statement 98, an amendment specifying sale-leaseback accounting rules. These rules generally prohibit companies from immediately recognizing gain if substantially all of a property sold is leased back, regardless of whether the lease is a capital or operating lease. Instead, accounting rules generally require companies to defer and recognize the profit over the leaseback period.

Transactions must satisfy all of the following criteria and requirements to qualify as sale-leasebacks under GAAP:

- The seller/lessee actively uses the property in its trade or business.
- The sale-leaseback`s payment terms demonstrate the buyer/lessor`s initial and continuing investment in the property.
- The seller/lessee does not have continuing involvement in the real estate other than a normal leaseback. For example, it may not have an option to purchase the property (except a right of first refusal on a fair-market-value purchase offer), guarantee the property`s residual value, or sublease more than 10 percent of the property.

Sale-Leaseback or Financing?

If a transaction does not qualify as a sale-leaseback under FASB 66 or FASB 98, the seller/lessee must account for the transaction as a financing, in which case the buyer is treated as a lender.

To determine whether or not a transaction is considered a sale-leaseback for tax purposes, companies must consider the following issues.

- Does the property`s purchase price approximate the fair market value? If so, it indicates that an arm`s-length transaction has taken place.

- Does the transaction lack economic substance? A sale-leaseback and any tax benefits would be disallowed if the seller/lessee controls the property`s economic upside and the economic relationship between the seller and buyer essentially is unaltered.

Companies should consider hiring an adviser to assist in evaluating alternatives, structuring the transaction, finding the appropriate sale-leaseback capital providers, and negotiating the specific terms.

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