

Look Before You Lease: An Overview of Sale Leaseback Transactions

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Sale-leaseback transactions have long been popular to allow operators of businesses to enjoy the use of properties, without the burden of owning the property. Investors involved with sale leaseback transactions enjoy predictable rates of return with defined risk and, usually, low operational obligations. Recent changes in accounting and tax laws, as well as experiences learned during the Great Recession may impact these transactions in the future.

I. Overview of a Sale-Leaseback and Benefits

A sale-leaseback is generally the sale of real property (although technically it could refer to any asset) to a purchaser who immediately leases the property back to the seller. Although the lease actually follows the sale, both are negotiated and agreed to as part of the same transaction.

The primary benefit to the seller, who becomes the tenant, is to convert an illiquid asset into a liquid one. In other words, the transaction frees up cash for the seller/tenant in the amount of the purchase price which the seller/tenant can then use for other purposes. Presumably, an ongoing business can achieve a greater return on investment or resolve financial or other impediments to growth by using its cash for its core business, rather than holding real estate. In addition, managing cash could be more efficient and less costly from an administration standpoint than managing real property.

A sale-leaseback may also provide tax benefits for the seller/tenant. Whereas the seller/tenant would have received depreciation expense for tax purposes when it owned the real estate, it will receive a full deduction for the amount of rental payments made in the year as a direct expense. (Although a tenant may have an increased annual cash obligation – i.e., rent - that it did not have when it owned the real estate, which could have a corresponding negative impact on other financial metrics.)

The primary benefit to the purchaser, who becomes the landlord, in a sale-leaseback is the income stream from the lease and the residual value of the real estate. Presumably, any purchaser in a sale-leaseback is primarily in the business of acquiring and managing real estate. So the purchaser/landlord obtains a new investment property in its portfolio that provides an acceptable projected return.

II. Drawbacks of a Sale-Leaseback

1. Tax Issues

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There are possible drawbacks to a sale-leaseback as well. Sale-leaseback transactions can have disadvantageous tax consequences for the parties involved. Among the risks are having the sale-leaseback classified as a financing transaction for federal income tax purposes, having to immediately recognize the gain on the sale, and incurring transfer taxes on the leaseback portion of the transaction.

The IRS may characterize the sale-leaseback transaction as a financing transaction, rather than a true sale-leaseback. Such a characterization means that the seller/tenant would be deemed to own the property for income tax purposes and would, therefore, depreciate the property, instead of the purchaser/landlord.⁴ Additionally, the seller/tenant may not be able to fully deduct the rental payments as an annual operating expense as the IRS may only permit deduction of the component of rent that is deemed "interest" on the financing transaction. Since depreciation of the property might be one of the purchaser/landlord's benefits from the transaction, losing the ability to claim depreciation on the property could be problematic for the purchaser/landlord.

If the sale-leaseback involves an option to repurchase, the IRS is more likely to classify it as a financing transaction rather than a true sale-leaseback. The IRS's argument is even stronger if the rent paid by the seller/tenant plus the purchase option price equals the original price the purchaser/landlord paid for the property plus a return that is equal to current market interest rates.⁵ In this case, the purchase price of the property is viewed as a loan to the seller/tenant, rather than a true sale and leaseback of the property.⁶ The drawback for this is that the seller/tenant gets the benefit of claiming depreciation, not the purchaser/landlord. To avoid this situation, the parties should make sure that if a repurchase option is included in the lease, such repurchase option should be for fair market value, rather than a discounted or pre-determined value.⁷

The Supreme Court weighed in on this issue, in the case of Frank Lyon Co. v. United States, where it ruled on the issue of when a sale-leaseback is a true sale-leaseback, rather than a financing transaction.⁸ In that case, a bank had entered into a sale-leaseback agreement with an investor. The investor took title to the building while it was under construction by the bank and then simultaneously leased the building back to the bank. The investor also obtained both a construction loan and permanent mortgage financing for the building. The rent for the building was equal to the principal and interest payments that would amortize the mortgage loan over the same period. Once the loan was paid off, the annual building rent would decrease. The bank also had repurchase options throughout the term of the lease. The prices for these repurchase options were the sum of any unpaid balance of the mortgage, the investor's original investment in the property, and interest on that investment.

On his federal income tax return the investor, as owner of the building, claimed depreciation and interest deductions for the building and mortgage loan. The Commissioner of the Internal Revenue Service denied the investor's deductions – stating that the investor was not the owner of the building for tax purposes and determining that the sale-leaseback transaction was

⁴ Stuart M. Saft, 2 COM. REAL ESTATE FORM 3D § 10:5 (Nov. 2016 update) & Arnold and Alvin Arnold & Myron Kove, 1 MODERN REAL ESTATE PRACTICE FORMS § 1:41 (Nov. 2016 update).

⁵ Alvin Arnold & Myron Kove, 1 MODERN REAL ESTATE PRACTICE FORMS § 1:41 (Nov. 2016).

⁶ Alvin Arnold & Myron Kove, 1 MODERN REAL ESTATE PRACTICE FORMS § 1:41 (Nov. 2016).

⁷ Fed Tax Coordinator L-6302.2 (2d) (current through Oct. 2016).

⁸ *Frank Lyon Co. v. U. S.*, 435 US 561 (1978).

actually a financing transaction. The investor challenged this determination. The issue before the Supreme Court was whether this was a true sale-leaseback, making the investor the owner of the building, or rather a financing transaction, where the bank would be the owner of the building. After analyzing the entire transaction as a whole, the Court held that it was a bona fide sale-leaseback, and not a financing transaction, and the investor had properly claimed the deductions.⁹ The rule from that case is that where

there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the [g]overnment should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts.¹⁰

A few of the important factors from the Court's analysis was that this was an arms-length transaction, that the investor alone was liable for the mortgage loan and that the investor had accounted for its liability under the mortgage loan on its own balance sheets.¹¹

One takeaway from this case is that parties entering into a sale-leaseback transaction need to be aware that the Internal Revenue Service will review sale-leaseback agreements as a whole, and not just based on the title of any executed documents, to make sure there is a legitimate business purpose underlying the transaction, other than avoidance of tax consequences.

A second disadvantage of a sale-leaseback is the possibility of the seller/tenant having to recognize all of the gain on the initial sale of the property, which could result in immediate negative tax consequences.¹² If the seller did not hold the property for at least one year, any gain on the property would be considered a short-term capital gain and could be treated as ordinary income taxed at the seller's regular income tax rate, rather than the long term capital gains rate (which is usually lower).¹³ This may offset all or part of the advantages to the seller from the sale-leaseback transaction.¹⁴ Depending on the seller/tenant's tax basis in the property, the amount of that gain could be large.

A third disadvantage to sale leaseback transactions is the possibility of double transfer taxation – paying transfer tax on both the sale of the property and another transfer tax on the subsequent leasehold interest. Some states, such as New York and Pennsylvania for example, impose transfer tax on the grant of long-term leasehold interests.¹⁵ Therefore, when a seller/tenant

⁹ *Frank Lyon Co.* at 578-79.

¹⁰ *Frank Lyon Co.* at 583-84.

¹¹ *Frank Lyon Co.* at 577.

¹² *Stuart M. Saft, Sale/leaseback Transaction, 21 West's Legal Forms, Real Estate Transactions, Commercial § 15.11 (Nov. 2016 update).*

¹³ 26 U.S.C. § 1222(1).

¹⁴ *Sale-Leaseback Transactions, 25-21 Current Legal Forms with Tax Analysis § 21.13.*

¹⁵ 20 N.Y. C.R.R. § 575.7. (making leaseholds where the sum of the term of lease and any options for renewal exceeds forty-nine years subject to New York Real Estate Transfer Tax); 61 PA. CODE § 91.193(b)(24) (making leaseholds for terms of thirty years or more subject to Pennsylvania Realty Transfer Tax).

sells property and then subsequently enters into a lease to lease it back from the purchaser, the seller would pay transfer tax on the initial sale and then, depending on the structure of the transaction, another transfer tax could be due and owing on the grant of the leasehold interest. This is an aspect of sale-leaseback transactions of which parties should be aware.

Another issue to consider when analyzing the tax treatment of sale/leaseback transactions is whether the lease is classified as a capital lease or an operating lease. Under a capital lease, the seller/tenant deducts only the “interest” portion of the rent payment. The lease is more like a loan, and the asset is treated as being owned by the tenant and stays on the tenant’s balance sheet. Under an operating lease, the tenant deducts the entire rent payment. Payments are considered operational expenses and the asset being leased stays off the tenant’s balance sheet. Including a purchase option in a lease may cause the transaction to be treated as a capital lease. However, many leases do contain “right of first offer” and/or “right of first refusal” provisions that are typically permissible under the applicable accounting standards.¹⁶

The tax treatment of sale-leaseback transactions may get more complicated in the coming years based on new accounting standards issued by the Financial Accounting Standards Board (“FASB”) on February 25, 2016. Under ASC 842, tenants will need to recognize virtually all leases on their balance sheets. However, for income statement purposes, FASB will retain the practice of classifying leases as operating or capital based on a number of factors, as outlined above. Despite retaining essentially the same standards for income statement purposes, the new standards may impact U.S. tax accounting methods, deferred tax accounting, state taxes and transfer pricing. For example, companies’ tax departments may need to review such aspects such as the treatment of tenant improvement allowances, treatment of lease acquisition costs, and computation of state franchise tax rates.

2. Purchaser/Landlord and Seller/Tenant Relationship

Other potential drawbacks for the sale-leaseback transaction arise from the landlord-tenant relationship. Some of these issues include the possible loss of flexibility in the use of the property, rent issues, reliance on a third party for upkeep, a seller/tenant’s loss of any post-lease interest, and the possibility of a landlord bankruptcy.

A. Loss of Flexibility by Seller-Tenant

Sale-leaseback transactions may cause the seller/tenant to lose flexibility in its use of the property. The seller, as tenant, would have to comply with restrictions imposed by the purchaser/landlord. As a direct owner/operator, the seller would only be bound by applicable land use laws and recorded restrictions. While the seller presumably wants to maintain flexibility in its use of the property, the purchaser/landlord may impose lease covenants that are designed to protect its investment, such as use restrictions, restrictions on the ability to assign the lease or to sublet the

¹⁶ Peter E. Fisch & Mitchell L. Berg, *Sale-Leaseback Transaction*, NEW YORK LAW JOURNAL – REAL ESTATE TRENDS (Feb. 18, 2015).

property.¹⁷ As a result of these competing interests, use restrictions are typically a subject of extensive negotiations in sale-leaseback transactions.¹⁸

Another issue with loss of flexibility by the seller/tenant is that if the seller/tenant wants to close operations, it may be costly to break a lease or buy out of a lease. This could impair the seller/tenant's ability to move out of uneconomic locations and could affect transactions at the company's corporate level.¹⁹ As a result, the seller/tenant will want to make sure it has the right to "go dark."²⁰ The seller/tenant may also want broad rights to sublet or to assign the lease as options for dealing with an undesirable location.²¹

B. Rent Issues

Another disadvantage of the sale-leaseback transaction for the seller/tenant is that the cost of rent over the term of the lease may be higher than the cost of carrying the property had the seller/tenant continued to own it.²² Additionally, even if a property's fair market rent decreases, the seller/tenant may still be locked into the higher rental payments that were negotiated when the sale-leaseback was negotiated.²³ The seller/tenant should also carefully consider whether the negative impact on other financial metrics from payment of rent is offset by the positive impact of the sale-leaseback transaction. This is a risk the seller/tenant will have to take in order to take advantage of the benefits of a sale-leaseback transaction.

C. Reliance on Third Party for Upkeep

Sale-leaseback leases are typically triple net leases where the seller/tenant is obligated to pay property taxes, insure and maintain the property.²⁴ While this may involve greater expense and management oversight for the seller/tenant, it can help ensure the seller/tenant does not have to rely on the purchaser/landlord, or a third party, for property maintenance and repairs. Depending on the type of operation at the property (for example, manufacturing operations with intellectual property to be protected, or health care operations where HIPPA concerns exist), having the seller/tenant retain responsibility for maintenance and upkeep can also assure that the property remains secure from third party access to the property. Typically, the rent paid under the lease will reflect whether the rent is triple net or gross or something in between.

D. Seller/Tenant Has No Interest at End of Lease Term

¹⁷ Peter E. Fisch & Mitchell L. Berg, *Sale-Leaseback Transaction*, NEW YORK LAW JOURNAL – REAL ESTATE TRENDS (Feb. 18, 2015).

¹⁸ Howard E. Schreiber, *Hot Button Issues of Sale Leaseback Deals*, REAL ESTATE WEEKLY (Nov. 27, 2013), available at <http://rew-online.com/2013/11/27/hot-button-issues-of-sale-leaseback-deals/>.

¹⁹ Peter E. Fisch & Mitchell L. Berg, *Sale-Leaseback Transaction*, NEW YORK LAW JOURNAL – REAL ESTATE TRENDS (Feb. 18, 2015).

²⁰ Peter E. Fisch & Mitchell L. Berg, *Sale-Leaseback Transaction*, NEW YORK LAW JOURNAL – REAL ESTATE TRENDS (Feb. 18, 2015).

²¹ *Evaluation of the Sale-Leaseback as a Financing Vehicle* (5-6 Real Estate Financing § 6.03).

²² Stuart M. Saft, 2 COM. REAL ESTATE FORM 3D § 10:5 (Nov. 2016 update).

²³ Stuart M. Saft, 2 COM. REAL ESTATE FORM 3D § 10:5 (Nov. 2016 update).

²⁴ David K. Hales, *A Practical Guide to Sale/Leaseback Transactions*, CLEVELAND METRO. BAR J., 38-39 (Oct. 2015).

At the end of the lease term in a sale-leaseback transaction, absent a purchase option, the seller/tenant typically has no ownership or occupancy interest in the property. Then the seller/tenant has to either negotiate for an extension of the lease, presumably at the then market rent, or has to repurchase the property at its then market value.²⁵ If the seller/tenant is unsuccessful in these options, it would have to relocate to another location. The seller/tenant should be mindful of this issue and plan many months or years in advance to secure control of the property or make plans to relocate. This can be particularly important for manufacturing facilities which have long development lead times if the seller/tenant has to relocate or build a new facility.

Additionally, with no interest at the end of the lease term, the seller/tenant does not benefit from the property's appreciation because any increased value belongs to the purchaser/landlord.²⁶

E. Landlord Bankruptcy

The possibility of a purchaser-landlord filing for bankruptcy also presents another possible drawback for the sale-leaseback transaction. If a purchaser-landlord files for bankruptcy, it is possible the bankruptcy trustee may reject certain executory contracts.²⁷ This could include the seller-tenant's right to renew the lease as well as any repurchase options the seller-tenant may have negotiated for.²⁸

A landlord who files for bankruptcy protection may elect to retain or elect to terminate any unexpired lease it has entered into.²⁹ This could present a difficult situation for a tenant faced with a landlord's bankruptcy. However, there is still protection for a tenant when a landlord elects to terminate an unexpired lease. When the debtor landlord rejects the lease, the tenant can either treat the lease as terminated, or stay in possession and keep certain of its rights under the lease.³⁰ The tenant will be required to meet its payment obligations to the landlord post-rejection and in return will continue to enjoy the benefits from its right to possession for the balance of the lease term as well as any extensions. When a tenant decides to remain in possession, the tenant may be able to withhold part of the lease payments as an offset against any nonperformance by the landlord.³¹ The tenant is not then able to assert a claim against the landlord for nonperformance under the lease.³² However, the lease may prevent the tenant from withholding a portion of the rent as a setoff for the landlord's nonperformance.³³

²⁵ Stuart M. Saft, 2 COM. REAL ESTATE FORM 3D § 10:5 (Nov. 2016 update)

²⁶ Stuart M. Saft, 2 COM. REAL ESTATE FORM 3D § 10:5 (Nov. 2016 update)

²⁷ *Evaluation of the Sale-Leaseback as a Financing Vehicle* (5-6 Real Estate Financing § 6.03).

²⁸ *Evaluation of the Sale-Leaseback as a Financing Vehicle* (5-6 Real Estate Financing § 6.03).

²⁹ See 11 U.S.C. § 365.

³⁰ John D. Ayer, Michael L. Bernstein, & Jonathan Friedland, *Chapter 11 – "101" -Bankruptcy Issues for Landlords and Tenants*, Amer. Bankr. Inst. J., Oct. 2004, at 54-55, available at <http://www.abi.org/abi-journal/bankruptcy-issues-for-landlords-and-tenants>.

³¹ IMPACT OF BANKRUPTCY ON A REAL ESTATE LEASE, <http://www.jaburgwilk.com/news-publications/bankruptcy-and-real-estate-lease> (last visited Dec. 9, 2016).

³² JOHN D. Ayer, MICHAEL L. Bernstein, & Jonathan Friedland, *Chapter 11 – "101" -Bankruptcy Issues for Landlords and Tenants*, Amer. Bankr. Inst. J., Oct. 2004, at 54-55, available at <http://www.abi.org/abi-journal/bankruptcy-issues-for-landlords-and-tenants>.

³³ IMPACT OF BANKRUPTCY ON A REAL ESTATE LEASE, <http://www.jaburgwilk.com/news-publications/bankruptcy-and-real-estate-lease> (last visited Dec. 9, 2016).

III. Capitalization Rates and Sale-Leaseback Transactions

A capitalization rate or “cap rate” is a short-cut way to value income producing real estate that is commonly used by brokers and investors. A cap rate is determined by taking the net operating income of the property and dividing it by the purchase price. For example, if a property has a net operating income of \$100,000.00, and the sales price is \$2,000,000.00, the cap rate is 5%. Although it sounds intuitively wrong, the lower the cap rate, the higher the purchase price. So an investor who is willing to purchase property at a 5% cap rate is willing to pay a higher purchase price than an investor who is willing to purchase the same property at a 10% cap rate.

Note that a cap rate is not a real “return on investment” analysis. A cap rate merely shows the projected return for one year as if the property were bought with all cash. It does not factor in financing, escalating or decreasing costs, increasing or decreasing rents, or the length of the income stream. All of these factors will change the actual return on investment.

One of the keys in calculating the cap rate is correctly calculating the net operating income. Generally, the net operating income is gross income minus operating expenses. Note that capital expenditures, depreciation and mortgage interest payments are not operating expenses and are thus not deducted from gross income to determine net operating income, although all of these factors can have a significant impact on the actual return on the purchaser/landlord's cash investment. Gross income means generally the aggregate rent. Pass through items, to the extent they are fully paid by the tenant end up being a wash since they are added to rent and then subtracted as operating expenses. However, if the lease includes fixed rent or gross rent provisions or caps on pass through items which render the additional rent more or less than the actual expenses, an adjustment would be made. Items such as management fees, administrative expenses and other operational expenses need to be specifically analyzed, and may have to be adjusted to a fair market cost. Two different investors may operate the property differently and thus have different operating expenses. A purchaser cannot just accept the seller's operating expenses as is without analyzing and then perhaps normalizing those expenses.

It is important to recognize that a cap rate cannot be the sole analysis of an investment purchase from the purchaser's standpoint; it is merely a short-cut tool to compare investments generally on a summary basis. Nonetheless, because it is so often used by real estate professionals, it is important to understand cap rate analysis so you can understand what your client and advisers are saying.

Obviously, average cap rates will differ based upon geographical location and type of property. For example, Real Capital Analytics (“RCA”), a company that specializes in reporting on the players and trends that drive the commercial real estate markets, reported in October of 2016 that the average cap rate for office space in Manhattan year to date was 4.3% while the average cap rate for office space in Suburban Cincinnati, Ohio year to date was 9.1%. The average cap rate year to date for multi-family properties in St. Louis, Missouri was 7.7% while the average cap rate year to date for multi-family properties in Austin, Texas was 5.8%.

Another reason to analyze cap rates is because cap rates have a direct impact on sales volume. If cap rates are down, it means that sellers are demanding and perhaps getting a higher purchase price. Higher prices usually mean less activity. RCA commented that the sales volume

of Suburban office assets was up because of the high cap rates and thus low purchase prices, while Central Business District office sales were down reflecting the low cap rates and thus high purchase prices. Similarly, RCA commented that retail cap rates were down from last year and not surprisingly then sales volume was down too. Multi-family continues to be a well performing segment. Although sales volume is down, RCA points out that October, 2015 was an extraordinary time for sales of multi-family properties and that average cap rates of 5.7% portend to a healthy sales environment. Analyzing cap rates can be an important tool in understanding commercial real estate capital trends.

Because sale-leaseback transactions are financial structures which allow the seller/tenant to monetize the value of its property and which provide an investment vehicle for the purchaser/landlord, understanding the pricing and the factors that impact pricing is critical to understanding the business relationships involved with sale-leaseback transactions.

Sale-leaseback transactions are primarily evaluated by the annual rate of return the buyer/landlord will achieve for the transaction. In order to achieve a particular cap rate for a transaction, the parties will adjust either the net annual rent paid by the tenant or the purchase price, since those are the factors which determine the cap rate.

Most sale-leaseback transactions are “priced” by determining what cap rate the investor should achieve. The particular cap rate sought by an investor is determined by the individual characteristics of the transaction as well as by macro-economic conditions. The primary determinant of the cap rate for a particular transaction is the risk and reward associated with the particular tenant, including any credit enhancements offered by the tenant. A transaction involving a less risky tenant will typically include a lower cap rate than one involving a riskier tenant. A lower cap rate might result in either lower annual rent or a high purchase price for the seller/tenant. So, a well-known tenant with strong financials, like McDonalds, might be viewed as less risky than a start-up business with no track record. A tenant which can provide a large security deposit or a guaranty from a credit worthy guarantor is likewise viewed as less risky and might involve a lower cap rate. The quality of the location (i.e., can the property be re-let easily if the tenant fails, are there environmental issues present, are the improvements in good order and condition) can also impact the cap rate involved, since it impacts potential risk for the investor.

Macro-economic conditions can also impact the cap rate sought by investors. In a low interest rate environment, cap rates might be lower as well. The presence of more investors, including institutional investors, like pension funds and mutual funds, impacts cap rates since the availability of more capital may drive cap rates lower as investors “compete” for investment projects.

The parties’ need to achieve certain cap rates, and therefore, certain purchase price or rent amounts, can impact legal issues. For example, the purchaser/landlord or its lender may seek clarification on environmental issues, including indemnities and releases, from the seller/tenant, in order to mitigate risk. The parties may spend more time negotiating lease guaranties and default provisions under the lease to lower the risk of default for the purchaser/landlord, if the cap rate is low or the spread between the cap rate and certain bond market bench marks are narrow in order to protect the income stream. The purchaser/landlord may want the ability to accelerate the rent or to seek other default remedies, or it may seek expedited eviction rights so it can gain control of

the property and re-let it quickly, if needed. The purchaser/landlord may also impose more obligation on the seller/tenant to remove trade fixtures and signage at the end of the term, so the purchaser/landlord can re-let the property quickly. Lawyers should understand how each of these factors might impact the transaction's cap rate, purchase price and annual rent.