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
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. 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. 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. 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.

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. 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

---

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).
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).
\(^15\) 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).