Sales-Leaseback: A Financing Alternative in a Transitioning Economy

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To survive in today's market as a provider of capital, whether you are a commercial broker, mortgage banker, correspondent, lender or investor, one axiom has proven true time and time again: your worth and ability to get paid is uniquely tied to the benefit you bring to a transaction, or what's more commonly known as your "value-added". The greater your value-added, the greater your ability to earn and ultimately to survive turbulent markets which experience the natural ebb and flow to which all sectors of the economy are subject.

As many *Scotsman* readers have found, the residential mortgage industry has become more of a commodity. The continuing proliferation of lenders with specialized mortgage products competing with higher and higher LTVs, streamlined guidelines, and the mass marketing that constantly solicits borrowers directly on behalf of lenders has ripped away the residential mortgage brokers' veil of "value-added". As that value-added continues to diminish, so will the brokers' ability to prosper in an industry that has been quick to deliver mortgages directly to the borrower, circumventing those pioneers that built the industry.

For this reason, many residential brokers have made the transition to becoming providers of commercial mortgages in order to supplement their waning income in a mature residential industry. As a result, there is a tremendous increase in the number of new commercial brokers. It's not hard to foresee the commercial real estate industry accelerating with this increase in new brokers chasing proportionally fewer commercial deals. Throw into the mix the exposure and cycles typically associated with the real estate market, and you have a situation in which your value-added as a commercial professional can quickly evaporate without sufficient additional product and knowledge. Being able to think outside the commercial mortgage box will be a tremendous advantage to commercial providers willing to spend the time to learn about some of the alternatives available to businesses trying to survive in a transitioning economy.

Historically, a sales-leaseback might have been the only solution available to a troubled company after a review by the local bank's credit manager and a "no thanks" due to poor credit and/or weakening financials. Sales-leasebacks utilizing discounted real estate holdings were often viewed as a bitter pill for a troubled company needing to create cash-flow. In today's weakened economy, chief financial officers are pressed to find new strategies to produce revenue while protecting capital. For similar benefits, many corporations are commonly employing sales-leasebacks using machinery and equipment to support a sagging balance sheet and to potentially offset net-operating losses that might otherwise expire.

Financially, a company executes a sales-leaseback by surrendering ownership to an asset (typically equipment, machinery, real-estate, or corporate division/business) at fair market value (FMV), and, in return, receives a lump-sum payment. In exchange, the new owner agrees to lease the property back to the original company. From a tax perspective, a sale-leaseback provides the party extending the credit (lessor) of the transaction all the benefits of ownership, including depreciation benefits, while the party receiving the credit (lessee) of the transaction can potentially enjoy the benefits of booking the transaction as a taxable sale. However, an important point to consider is where the depreciated book value of the asset is reflected on the balance sheet in relation to the asset's fair market value (FMV). If the FMV of an asset is greater than the depreciated book value, a sale-leaseback could create a book and tax gain; conversely, if the FMV of an asset is below the depreciated book value, a sale-leaseback would create a book and tax loss. These situations can often exist by design, but, when

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accounting for the depreciated book value of an asset is not consistent with the expectations of management with respect to the FMV of the asset, the outcome can be disastrous. Many large institutions make a common practice of "revenue management" through effective use of sales-lease-backs as a cash and/or tax management tool.

Although an effective tool, a sale-leaseback can also present very specific challenges. Being able to evaluate a sale-leaseback transaction requires an understanding of each party's objective, financial statement positions, and the regulations that specify how leases should be accounted which are issued by the Financial Accounting Standards Board (FASB—more commonly referred to as FASB-13). FASB-13, the main statement for lease accounting, was issued in 1976.

While it is not always clear which party is to be the "owner" of the asset for tax reporting purposes and/or financial reporting purposes and, conversely, who will be the user of the asset, FASB-13 can lend some clarity. A basic premise of lease accounting portends that some leases are rentals while others are disguised acquisitions. As an example, if you were to lease office space for 5 years, it is reasonable to expect the space to be worth as much, or possibly more, at the end of the period. This type of lease is called an *operating lease*.

Conversely, if you were to lease a computer for 5 years, at the end of the period, the computer would likely be worthless. In the latter case, the lessor typically anticipates this and charges the lessee a payment that recovers all of the costs of the asset with a profit built in. This is essentially a purchase-on-terms called a *capital lease*, which must be supported on the lessee's financial statements with an asset and corresponding liability. Rental payments are considered repayments of the loan; depreciation and interest expense, rather than rent expense, are shown on the income statement. To determine if the transaction is classified as a capital lease, a good rule of thumb is to see if any one of the following four criteria is met:

1) The lease conveys ownership to the lessee at the end of the lease term;

2) The lessee has an option to purchase the asset at a bargain price at the end of the lease term;

3) The term of the lease is 75% or more of the economic life of the asset;

4) The present value of the rents, using the lessee's incremental borrowing rate, is 90% or more of the fair market value of the asset.

These guidelines from FASB-13 should help business owners to ask the right questions. A capital lease is essentially a purchase that needs to be reflected on the company balance sheet; an operating lease can be treated as a footnote to the financial statements and is not required to be reported on the balance sheet. In either case, while a lease can be the perfect cure for an ailing economy, it is essential that suitable tax and financial counsel be retained to advise management of the benefits and reporting requirements that accompany these tools to cash and financial management.

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