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***66 THE REAL ESTATE SALE-LEASEBACK TRANSACTION: A VIEW TOWARD THE 90S**

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This Article Explores the Advantages and Disadvantages of the Sale - Leaseback with a View Toward Its Use as a Practical Financing Tool in Real Estate Transactions. It Will Also Seek to Exact an Understanding of the Most Recent Case Law with an Eye Toward Its Application in Governing the Area of Sale-Leaseback Transactions. Finally, the Author Offers an Outline for a Sale-Leaseback That Comports with the Case Law and Adequately Addresses the Concerns of Both the Courts and the Internal Revenue Service (IRS).

In the corporate world of balance sheets and income statements, sales forecasts and profitability, and debt-to-equity ratios and subordinated debt, the bottom line remains the bottom line. And with the United States in the throes of a recession of unknown proportion, large and small businesses search for ways to avoid hitting rock bottom. One way for businesses to do this is to reduce their costs. One of the ways businesses help their bottom line is to reduce their costs by using more creative financing tools, which will enable them to take advantage of many economic and tax benefits and, in turn, make them more financially stable and attractive. One of those financing alternatives is the real estate sale-leaseback transaction, which creates opportunity for businesses to exact greater cash flow while reapportioning some of its financial liability to make these businesses more profitable.

The Sale-Leaseback Generally

A sale and leaseback of real estate typically involves the sale of either undeveloped land together with existing improvements *67 by a land developer or business concern to an institutional investor that simultaneously leases back the property to the previous owner for an extended period under a net lease [\[FN1\]](#) arrangement. [\[FN2\]](#) While defining a sale-leaseback is relatively simple, structuring one is extremely complicated, especially in light of the lack of uniformity of the positions held by the IRS and the courts regarding the various issues involved. [\[FN3\]](#) As a general proposition, for sale-leasebacks to be considered for tax purposes, they must not be subject to attack by a claim of being a "sham transaction." That is, the sale-leaseback must have some defined, material business purpose other than to gain tax advantages. The IRS's attack on sale-leasebacks takes many forms that will be discussed at length.

Advantages and Disadvantages of the Sale-Leaseback

The sale-leaseback of real estate creates opportunities for both seller- lessees and buyer-lessors to rework their financial positions with limited trial and tribulation. In short, the advantages to the seller-lessee are mainly to be found in the greater cash flow that sale-leasebacks create; the advantages for the buyer-lessor are found in portfolio management and available tax and nontax deductions. There are also drawbacks that sale-leasebacks create and that serve to deter businesses from their use.

Seller-Lessee

The first major advantage that a seller-lessee obtains by use of the real estate sale-leaseback is the infusion of working capital that is necessarily provided by the sale of the property. Obviously, the sale and subsequent leaseback allows the seller-lessee *68 to use 100 percent of the property's market value in cash for more productive purposes, [FN4] including the creation of working capital, the ability to invest in more profitable enterprises, and the ability to of the seller-lessee to retire some preexisting debt. [FN5] For example, this factor makes the sale-leaseback appealing to firms in capital-intensive industries that require cash infusions for the purchase of inventory and the payment of operating expenses. [FN6] By obtaining 100 percent financing of the property, the seller-lessee can realize a greater amount of that needed working capital than would be possible in a conventional mortgage, in which typically lenders and/or applicable law rarely allow the loan-to-value ratio to exceed 75 percent to 80 percent of the property's true market value.

The second major round of advantages available to the seller-lessee by way of this transaction is the balance sheet improvements afforded thereby. Primarily and fundamentally, the increased cash position creates an immediate upsurge in the company's short-term borrowing power. Second, if the property is a mortgaged one, the sale-leaseback is removed from the balance sheet, which serves to further balance sheet viability. Finally, if the subsequent leaseback can be termed an "operating lease," [FN7] the replacement of the financed property with an operating lease may reduce the debt-to-equity ratio of the seller-lessee's balance sheet. [FN8]

A third major advantage of the sale-leaseback from the perspective of the seller-lessee is the availability of a tax deduction *69 for the rental payments made as a result of the subsequent leaseback. In fact, the seller-lessee gains an added advantage over deductions available in conventional mortgage financing because use of the sale-leaseback affords the seller-lessee the ability to amortize the entire value of the property by deducting those payments to the buyer-lessor. In conventional mortgage financing, only interest payments and depreciation may be deducted by the borrower. As a result, the sale-leaseback becomes extraordinarily useful to the seller-lessee in situations in which the value of the land subject to sale-leaseback is unimproved, nondepreciable land. [FN9]

There are also some disadvantages from the standpoint of the seller-lessee. The first of these, and perhaps least significant and easily circumvented, is the fact that fee ownership of the land is lost by way of the sale. While the seller-lessee maintains substantial control over the property, the buyer retains an ownership interest in the property at lease end. The ability of circumvention of this event by the seller-lessee lies in its ability to include in the wording of the initial transaction renewal and repurchase options on the property. These options will be discussed at length later in the section that describes and attempts to summarize the current state of sale-leaseback law.

The second and potentially greater problem for the seller-lessee is the very real possibility that the IRS will recharacterize the sale-leaseback as a mere financing arrangement, as a like-kind exchange under Section 1031, or as a sham. Recharacterization would result in the forfeiture by the seller-lessee of many of its deduction advantages and any deductibility of the loss incurred on the sale of the real property to the buyer-lessor. The recharacterization problem will be discussed at length in the section that summarizes the current state of sale-leaseback law.