College of William & Mary Law School
William & Mary Law School Scholarship Repository

William & Mary Annual Tax Conference | Conferences, Events, and Lectures

1971

Leasing Arrangements

Lawrence P. Roesen

Repository Citation
Roesen, Lawrence P., "Leasing Arrangements" (1971). *William & Mary Annual Tax Conference*. 424.
https://scholarship.law.wm.edu/tax/424

Copyright c 1971 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
https://scholarship.law.wm.edu/tax

LEASING ARRANGEMENTS

MR. ROESEN:

Sale and leaseback and long-term leases are nothing new to the business community. They have been around for a long time but because of the great drive and impetus towards tax shelter and other economic benefits an unusual amount of interest has been created in this topic, but because of some of the provisions of the 1969 Tax Reform Act some of the glamor has been taken away from this drive but with the right facts and the right financial condition this approach is still very much alive. As you know, the sale and leaseback can be worked for tangible personal property or real estate using the land and buildings or just the land alone. I wish to comment on both types but will spend most of my time dealing with real estate as I feel this is the major area for tax shelter.

Sale and leaseback has become a recognized and conventional method for acquiring the use of property. Very simply stated the arrangement is one where property, real or personal, is sold and as part of the same transaction, at that time, or at a later time, the purchaser leases the identical property back to the seller. The selling price is usually geared to the value of the property, with the rental payments arranged so that the lessee pays an amount sufficient to return to the lessor his investment over the term of the lease together with interest on his investment. The interest factor in this type of arrangement is always higher than in other conventional type financing.

There are several non-tax motives in using a sale leaseback. Take for example, a situation where a growing business that has minimum working capital that has owned certain property for a long time and now has a substantial equity in those assets on its balance sheet. But this is equity in a fixed asset used to carry on the operation of the business and therefore, would not appeal to a banker if he was evaluating the financial position and the ability of the business enterprise to repay a prospective loan.

For a business enterprise that needs an appealing balance sheet, a sale and leaseback offers them the opportunity to take off a fixed asset, replace it with cash, and remove from the liability side of the balance sheet the current portion of the mortgage, as well as the long-term debt. This naturally, would greatly improve the working capital position of the entity. The tax implication must be considered, of course, which we will deal with later. Along with the improved working capital and the removal of the long-term debt, there must be reflected as a footnote the amount of monthly obligation on the lease, terms thereof, length it has to run, and any other pertinent information on the lease. This information disclosed as a footnote to the balance sheet normally does not have the same significant drawback to the banker or creditor that evaluates the financial position of the business, as opposed to the balance sheet having a minimum working capital posi-

tion. The lease is long-term and the corporation now has transferred an equity in fixed assets into liquid cash.

Besides being helpful as an aid to the balance sheet, sale and leaseback can be very useful when money is hard to get. In a tight money market it is often difficult to borrow funds through the mortgaging of real estate. Sale and leaseback of that same real estate that you would be interested in mortgaging is often being resorted to as a practical device to obtain necessary liquid funds for a particular purpose. Even where conventional funds are available a sale leaseback arrangement will provide more funds than other types of long-term financing. If property is sold, under this type of transaction, the price which is received for the property is normally the full 100% of the market value. Try to get that from a banker! Conventional lenders will normally only lend a percentage of the full value up to ⅔ or ¾ of the worth of the property.

A builder or developer may find that this means will enable him to complete a deal comfortably that might otherwise be shakey or force him to handle by himself or even with the funds he is able to get from the bank. We could take undeveloped land and sell it to a group of investors for cash and then lease it back on a long-term lease. This could even enable him to undertake the whole original plan and possibly not have any equity capital of its own in the project. In fact, I have handled a deal that as a promoter was putting the figures together, we acknowledged that the deal would have had marginal appeal to an investor, but with him leasing the land on a long-term basis the cash required decreased and made a very attractive package. After all, we know the investor is usually looking for cash flow and shelter, and is content with that.

A real estate dealer could offer a great opportunity, if he would proceed to purchase the land with one group of investors who are looking primarily for long-term steady income, and wanted security more than shelter. This first group could then lease the land to a second group, made up of parties who are looking for a means to shelter some of their other income and who are willing to take the risk involved in running an operation which the first group of investors were particularly seeking to avoid. The parties in the second group would, of course, be putting up only the funds needed to construct the building which would be less than if they had to buy the whole deal including the land under the buildings. The second large advantage to this arrangement for the second group of investors would be that the total cost of the investment would be depreciable in some manner. Thus, there are no wasted dollars that have been invested in assets on the balance sheet and which do not provide some shelter for this second group of owners.

I am also familiar with a deal where the mortgagee insurance company that wanted a piece of the action bought the land and then leased

it to a group in which they were a partner to build some apartments. To them it was the best of two worlds, a safe steady income along with an inflationary ride as a partner in the operating concern. The best part of this is that the operators probably will have little cash equity in the deal. Even if the cash flow is slightly reduced because of the lease arrangement, their percentage return on what they have invested in the project is even more significant than it was with the slightly higher cash flow and the higher cash investment.

The ground lease has certain advantages to the tenant regardless of whether it is part of a sale leaseback transaction or just an outright long-term lease. It greatly increases the amount of financing that is available to the tenant-builder and two, the amount of equity capital required for the project is greatly reduced and possibly eliminated as a result of increased financing; three, financial projection of the project from the tenant standpoint are vastly improved because ground rent paid is a deductible item for Federal income tax purposes as opposed to having capital tied up in nondepreciable land. Four, interest paid on larger mortgages is also deductible and five, a deal of ground leases may appeal to certain land owners that would not consider selling them because of the tax consequences to him.

The advantages to the landlord are that (1) he is able to lease his land at a valuation which he considers to be based on full worth and reflected in monthly net rentals. (2) He avoids a sale of the land and possible capital gain tax. (3) He secures permanent improvements on his property which is eventually turned over to him or his heirs at no additional cost. A tremendous disadvantage to the landlord would be for him to have to subordinate his interest in the lease to any mortgage on the improvement that may be put on his land. The tenant would ask him to do this because it permits the tenant to get more funds from the lendor. The lendor looks upon the loan, not as a leasehold interest but as a fee simple interest in the land. Since the landlord is pledging his fee by subordinating it as security for the tenant's loan, he would be entitled to a higher annual rate of return. A one or two percent equity participation is little to ask since he could lose his fee ownership altogether.

The various advantages and benefits that are available under the sale and leaseback and the long-term lease naturally carry with them certain tax problems that must be contended with at various stages of the transaction. The 1969 Tax Reform Act somewhat stiffened some of the problems and pitfalls arising from the transactions. Let us take a look at some of these tax considerations that plague us along the way and see what are the implications of each.

The Tax Reform Act of 1969 did not greatly affect the tax problems to the seller on the sale of tangible personal property. The Revenue Act of 1962 took excellent care of that with the Adoption of Section 1245 which calls for gain on the sale of personal property to

be taxed as ordinary income to the extent of depreciation taken after 1962 regardless of the method of depreciation. The change in the 1969 Reform Act that would affect a sale leaseback on personal property, is in the adoption of the minimum tax and the definition tax preference income. One of those items of income that must be included is excess accelerated depreciation on a net lease of personal property. It may be wise to bear in mind that all excess accelerated depreciation on tangible personal property is not involved only if it is on one subject to a net lease. A net lease is defined as one where operating expenses do not exceed 15% of the gross rents. There once was a time when an individual got a benefit out of leasing a large tangible personal property item. Now one would have to be careful on the old method of leasing airplanes, railroad cars and the like on a net lease basis.

In dealing with the sale leaseback, the first taxable transaction that takes place, of course, is the sale of the property to the purchaser-lessor and the seller must at that time consider his gain on the sale. If a ground lease is the only thing involved, and if the land has been held for investment and held for more than six months, all the gain to the seller should be capital gain. If a building is involved as part of the transaction we run into a more sticky and possibly less attractive situation to the seller. Between 1964 and 1970, gain on the sale of any depreciable real estate was taxed in the following manner:

(1) If property had been held for less than twelve months, then gain to the extent of any depreciation taken would be recaptured as ordinary income, and any excess gain would be treated as capital gain. (2) If property was held between twelve and twenty months then any excess depreciation taken since acquisition would be recaptured as ordinary income and any additional gain treated as capital gain. Excess depreciation is defined as the difference between what is taken on the accelerated method and what would be the depreciation on the same life on a straight-line method. (3) If the property was held for more than twenty months but less than 120 months, then the same excess depreciation is reduced one percentage point per month for the months held over the first twenty months and any excess gain over that would be capital gain. For example, if an asset was sold on December 25, 1969 and has been held for 45 full months up to that date, then your formula would be 45 months held, minus the first 20 months which would give you 25 months in excess of the first 20 months and your result is that the 25 months reduces the 100% down to 75% of the excess depreciation and would be recaptured as ordinary income.

Although these rules were somewhat revised in the 1969 Tax Reform Act, the rules just mentioned still apply to assets sold after 1969 as to amount of recapture of depreciation and length of time held as of December 31, 1969. Therefore, there are two groups of rules on recapture which will apply to assets acquired before 1/1/70 and sold after that date. One set to determine depreciation for the period

held before 1970 and the other set to determine for the period after 1969. As to the rules that apply after 1969, they are as follows:

Real Estate is first of all broken down into residential real estate on one side and all other commercial real estate on the other. Residential real estate recapture provisions provide that if the property is held between one month and 10 months, then 100% of the excess depreciation is subject to being taxed as ordinary income and any gain over that would be capital gain. (2) For property held for more than 100 months the same method of computing the percentage as under the pre-1969 rules would apply. The percentage of excess depreciation to be treated as ordinary income reduces 1% a month for each month held over 100 months until it has been held 200 months and then all gain would be capital gain. All other types of real estate, except residential real estate, have no reduction percentage and therefore, any sale of this type of commercial real estate after 1969 to the extent of any excess depreciation is fully subject to ordinary income treatment and no percentage reduction is allowed regardless of how long the asset has been held. But as I said before, even on these assets it must be kept in mind that the depreciation must be split between depreciation taken before 1970 and that taken after 1969.

Another important point that must be considered in dealing with the sale portion of the transaction is how much is the gain and how is it to be measured. In any sale leaseback, the seller is looking for cash and a lease on the property and the gain would be normally measured by the total of these two items as compared to the basis of the property he is disposing of. The sale and leaseback is considered one transaction and therefore, the seller would be said to be exchanging his fee simple ownership in the property for a leasehold interest plus cash. Section 1031 of the Revenue Code clearly spells out how this should be treated. If that lease is for more than 30 years then under this section, it would qualify for a swap of real estate and constitute a like exchange to the maximum extent of the cash received. The Code Section is quite clear exactly how the transaction should be treated as to the gain if the lease is for more than 30 years. But we run into a little sticky problem if the lease is for less than 30 years, because you must then consider the value of the lease plus cash in arriving at the gain on the sale. If the transaction is handled on an arm's length basis and the rental figure used in the lease is at the market value and not below market value it is normally said that there is no value on the lease because you are getting what you have to pay for. However, if the lease is for less than 30 years and the rate of rent is below the going market rate then IRS has been successful in placing a value on that lease and taking a gain over and above the cash received.

Of course, nobody sells in these transactions at a loss, but if there should be one, in which the leaseback was for a period of 30 years or more then, as I stated before, this section prevents the loss from being

recognized because it is a non-taxable exchange. However, should this happen, the loss would be treated as part of the cost of obtaining the lease and written off as a deferred item over the life of the lease. The actual anticipated life of the asset being leased has no effect here, even if it is shorter than the lease. Only the length of the lease is important. I want to point out that if you have a piece of property that you are selling at a loss then you must, in order to recognize that loss on the sale, make sure that the lease is for less than 30 years.

In determining the length of the lease for this purpose, as to whether or not renewals provided in the lease are added on to the original term of the lease becomes a question of fact. You must consider the period involved, the nature of the business, the life of the property, and the likelihood of exercise of the renewal.

On these sales you must also consider Section 1239 when selling to an 80% owned corporation lineal descendents, spouse, minor children and minor grandchildren. Under this section, all gain on depreciable property, real or personal, to the extent of all depreciation taken would be subject to ordinary income. Therefore, it must be noted that this is even more stringent than the recapture provision.

Once we have gotten over the hurdle of the sale and its tax consequences, then we must consider what are the tax benefits or drawbacks of the leaseback portion of the transaction. We must consider first of all the advantages of the seller-tenant, making rental payment vs. the owner taking depreciation and interest. The rental payments now being made by the seller-lessee are fully deductible, and to the purchaser-lessor are the equivalent of a return of capital plus interest. However, the payment to lessor, of course, must be treated as rent income and depending on what has been sold the purchaser-lessor would be entitled to deduct some depreciation expense against the rent. To the seller-lessee these rent payments may be higher than depreciation if that property is almost fully depreciated. Rental payments are geared to the entire value of the property including land, but if you own the project, of course, you would be able to deduct depreciation on the building only, and only as owner, your balance sheet would have capital tied up in unamortizable land.

In a leaseback, the lessor would certainly be a second user. His use of accelerated depreciation would be substantially limited under the 1969 rules. It is true that the purchaser-lessor would have a higher basis of depreciation even as second user but because his lack of fast write-off there would have to be something else in this transaction that appeals to him or else he will find another deal and obtain more tax shelter from it.

The other item that the seller-lessee is giving up, is his interest deduction. And in years after the early ones the interest begins to wane anyway. Therefore, if he owned an apartment project long enough to obtain capital gain under the recapture rules of Section 1250 an

apartment project could be sold at capital gain rates and the seller could not only realize his fair market value in cashdollars at that point, but on subsequent leaseback, he would deduct rental based on full current market value instead of just the declining interest and declining depreciation. He would have cash in his pocket, no investment in the deal and still be able to pull substantial cash flow out of the operation even though he must now make his lease payments. To the purchaser-lessor, there are also advantages. First of all, he has a passive investment similar to a mortgage but which offers a higher rate of return. Net lease arrangements normally do not require owners to operate the business. It is only the effects of the minimum tax on a net lease, which would prevent him from being thrilled about this opportunity. In addition, the purchase of the real estate is a hedge against inflation as property value has increased as the dollar value has declined. Even if improvements have declined significantly over the term of the lease, the value of the land normally has increased and will hold its value.

If, on the other hand, we consider only a long-term ground lease on a new project then the tax reform act has again limited their benefits from depreciation by providing that the maximum depreciation that can be taken on any real estate is 150% declining balance, and all used property must use the straight line method. A big exception to this is that in case of residential real estate, they may use 200% declining balance on new property but if it is used property the depreciation may not exceed 125% declining balance and must have a more than 20-year estimated life. Residential real estate, of course, is defined as any real estate in which 80% or more of the gross receipts come from residential tenants.

The real change affecting sale and leaseback involved in the 1969 Tax Reform Act appears to be in the area of the minimum tax. This is a wholly new provision of the law that affects a lease situation, contrasting an operating lease with a net lease. First of all, the minimum tax is a 10% tax on certain tax preference income, if those types of income exceed a specific exemption of $30,000.00 plus your normal income taxes for the year involved. The areas of tax preference income among others that affect the leaseback situation are: (1) All excess depreciation on real estate for that year must be considered. This provision has equal impact on all real estate regardless if it is part of a sale leaseback or not. The purchaser-lessor would be a second user and therefore would have limited use of accelerated depreciation. Thus one going into this transaction should be aware. (2) If after everything you have heard today about the 1969 Tax Reform Act and recapture depreciation you are still entitled to some capital gain on the sale, then the minimum tax requires you to include the untaxed portion of the gain in your total of tax preference income. (3) Excess investment interest to carry investment property—here we run into the distinction between an operating lease and a net lease.

Interest expense incurred to carry on an operating business is not included in this definition, but a net lease is within the definition of investment property. Therefore, any interest expense used to carry a net lease would be classified as investment interest expense. Net lease is defined as a lease where operating expenses are less than 15% of gross rents or a lease under which investor is guaranteed a specific return. For the years 1970 and 1971, excess investment interest of individuals, Subchapter S Corporations, and personal holding companies is treated as tax preference income item and subject to minimum tax. Effective for 1972, and thereafter, this excess investment interest will no longer be tax preference income but will be disallowed as a deduction to the extent of ½ of the excess investment that exceeds $25,000.00. Excess investment interest is the difference between the total investment interest expense minus the total net income from dividend, interest, rents, royalties, short-term gain and 100% of a long-term capital gain. One-half of this excess is disallowed as a deduction in the year incurred, and is allowed as a carryover to subsequent years and then faces a somewhat similar test. For example, interest incurred to construct property to be used in a trade or business interest on home mortgage or interest on an operating real estate deal comes within the exception. It might be said that if you have the headaches of operating your trade or business and if you merely receive your monthly checks with no concern than it is a net lease then, the income from these net leases is not in any way subject to the minimum tax. It is only interest which is used to finance this type of investment which could be subject to minimum tax or disallowance if it exceeds the preceding formula. Therefore, if purchaser-lessor borrows nothing, he has no problem. It is also important to note that a carryover of excess interest is allowed and possibly there will be no loss of interest deduction at all but just a shift in deduction from one year to another.

In summary, it appears that some of the glory has been taken out of the use of sale and leaseback, if it is done strictly for tax shelter. However, I feel the seller as well as the lessor will be using more and more of the ground lease for these tax shelter deals, either from sale and leaseback transactions or just on new deals where capital is at a premium and the investors want to put in as little as possible.