THE SALE AND LEASEBACK PROCESS
A taxpayer may want not only to sell a property and retain an economic interest, but also to continue using the real estate. An operating company, such as a corporation, frequently wants to convert its real estate into cash while at the same time using the property in its business operations. The company cannot meet these two objectives—a retained economic interest and continued use—through an outright sale. Its alternatives are to retain ownership of the property and obtain mortgage financing, or to sell the property and simultaneously lease it back from the purchaser.

The Choice between Mortgage and Lease Financing

The choice between these alternatives will depend primarily on the following factors:

1. The amount of capital the company can obtain for the real estate
2. The cost of capital
3. The tax effect of the transaction
4. The financial accounting treatment of the transaction
5. The residual value of the property
6. The rate at which the company can reinvest the capital (i.e., the company’s investment opportunity rate).

In order to weigh each of these factors and to see how they intertwine, we will start with an example of a $10 million dollar office building that is expected to grow in value over the next several years at a 5% annual compound rate. At that rate, the property will be worth approximately $26,500,000 within twenty years. Assume that the company’s reinvestment rate is 14%, that is, by reinvesting in its business the proceeds from the sale or financing of the property (whether the proceeds are obtained through a mortgage or a sale and leaseback), the company will make 14% per annum.

Under the mortgage alternative, the terms are as follows:

1. $7 million mortgage (or 70% of loan-to-value)
2. 11% interest rate
3. Twenty-year maturity
4. 100% amortization of the principal of the mortgage by maturity, requiring an annual debt-service constant of 12.58%, or $880,600 per year on $7 million

If the financing is obtained through a sale and leaseback, the terms are as follows:

1. Sale proceeds of $10 million
2. A twenty-year net lease, with the company paying all costs of operations and maintenance.
3. Annual net rent (after all operating and maintenance costs) of $1,100,000, or 11% on $10 million

In comparing these alternatives, we will look at each of the six factors in order:

1. AMOUNT OF CAPITAL:
The amount of new capital the company will receive under a conventional, non-recourse mortgage will typically be between 70% and 80% of the value of the real estate—or $7 million to $8 million in this example. The amount may be higher, if the company is recourse on the mortgage or enters into some of the other mortgage arrangements previously discussed, such as a participating mortgage. But in most cases the principal amount will be well below 100% of value.

In a net lease transaction, the company should receive the market value of the property ($10 million) since it is making a sale. In effect, the sale and leaseback arrangement is 100% financing, as compared with 70%-80% ($7 million to $8 million) under the mortgage.
2. COST OF CAPITAL:
The cost of capital for mortgage financing typically will be higher than in a net lease transaction. The mortgage cost is, by and large, a function of prevailing interest rates at the time of the financing, combined with the company’s credit standing. In this example, we have assumed an 11% rate, with annual debt-service payments of $880,600 over a twenty-year term for the use of $7 million of capital—or 12.58% on $7 million.

Under the net lease, we have assumed that the annual rent is $1,100,000. Since the company received $10 million for the sale of the property, its annual cost of capital is only 11%, as compared with 12.58% under the mortgage, a difference of 1.58% per year. If 11% were looked at as the equivalent of the debt-service constant on $10 million of financing, then the effective interest rate would be approximately 9.06%. A $10 million loan bearing interest at 9.06% will be fully amortized over twenty-years at a debt-service constant of 11%. This is 1.94% less than the 11% interest rate on the mortgage.

The difference between the cost of capital in a mortgage and a lease transaction is attributable to the fact that a purchaser who is leasing the property back to the company will usually accept a lower current return than a mortgage lender because, unlike the lender, the purchaser is entitled to the tax benefits of ownership, particularly depreciation. The purchaser will also, as owner of the property, be entitled to 100% of the residual value (including all of the capital appreciation) upon the expiration of the lease.

3. TAX CONSIDERATIONS:
Under most circumstances, the tax considerations favor the mortgage over the lease arrangement. As discussed earlier, mortgage financing is not a taxable event, since the company is not selling the property. Consequently, no tax is payable on the mortgage proceeds. Additionally, the company can continue to deduct depreciation as well as mortgage interest.

A sale-leaseback transaction can have serious tax consequences. The company will have to pay a tax on the gain from the sale, and it will no longer be entitled to deduct depreciation. On the other side of the ledger, the company will be able to deduct all of the rent payments, including that portion of the rent attributable to the use of the land.

It is not easy to generalize about the tax effects of each type of financing. They are determined by the specifics of the transaction because of the interaction among taxable gain, depreciation, and rent deductions. If the company has a high taxable basis in the property, it will, by mortgaging and retaining ownership, reap considerable tax benefits through depreciation deductions. By selling, the company will be giving up these benefits. Yet, with a high basis, the taxable gains from the sale will be quite low or nonexistent. And even though the company loses depreciation, it will be able to compensate for that loss to some extent through rent deductions.

Conversely, if the company’s tax basis is low, the value of the depreciation deductions declines. (For example, at a zero basis, the company has no further depreciations to deduct.) But if the company sells and leases back, there will be a large taxable gain. This may not deter the company from entering into a sale and leaseback, to the extent that the rent deductions and losses from other sources offset the tax effect of the gain.

Finally, the rents are deductible in full, while only the interest portion of the annual debt-service payments on the mortgage can be deducted. The importance of this distinction can be illustrated by comparing the effect on each $1 million of financing. Annual debt service on the twenty-year mortgage is 12.58%, or $125,800 per $1 million. Over twenty years, the total payments are $2,516,000 ($125,000 x 20). Of the $2,516,000, $1 million is principal and not deductible;
$1,516,000 is deductible as interest. Under the net lease, the annual rent for each $1 million of capital is $110,000 (or 11% per $1 million). Over twenty years, this totals $2,200,000, with the full amount being deductible.

4. BALANCE SHEET CONSIDERATIONS:
There can be material differences in the financial accounting or balance sheet treatment of each type of financing. In the case of the mortgage, the amount of the company’s indebtedness is increased by the amount of the mortgage—for example, $7 million. There is, of course, a corresponding $7 million increase in its cash position.

Except for these modifications, the company will continue to reflect the ownership of the property on its financial statements without any other change in condition. By contrast, in a properly structured sale and leaseback transaction, the company can upgrade its balance sheet significantly. To begin with, the sale should convert the $10 million of real estate into $10 million of cash. The company should not have to show any increase in its indebtedness, since it is not borrowing any money in order to obtain the $10 million. The company will increase its net worth by the difference between the sale price and the book value of the property, after adjusting the result for taxes on the gain. (The recognition of this increase in net worth will probably have to be spread over the term of the lease.) Finally, the company’s lease obligation will usually not have to be recorded directly as long-term obligations or liabilities on its financial statements.

Such favorable balance sheet treatment of a lease transaction—often referred to as “off balance sheet” financing—depends on careful structuring, including compliance with a long list of rather complicated accounting rules promulgated by the Financial Accounting Standards Board (FASB) in Statement of Financial Accounting Standards (SFAS) Nos. 13, 28, 66, and 98. These are the official standards by which accountants must treat and record leasing arrangement. Their ring of authority within the accounting profession is comparable to that of the Internal Revenue Code; their level of complexity and confusion is often seen as going beyond that of the Code.

Unless the company complies with these standards, the transaction will not be characterized as a “true” lease arrangement and the favorable balance sheet treatment described above will not be available. (Corvus will not go into detail as to how the lease will be reflected on the company’s financial statements in this document.) If the lease is not a “true” lease, among the possibilities are: the arrangement will not be treated as a sale, or it will be recorded as a long-term obligation similar to that of mortgage debt. A company entering a leaseback transaction must consult its accountant in order to determine whether a lease is a “true” lease within the meaning established by the Financial Accounting Standards Board and, if not, how it will be recorded on its financial statements.

Some of the more significant provisions of the FASB Statements can be briefly summarized:

1. The company must not have the right, through an option or otherwise, to get the property back at the end of the lease term at a zero cost or a bargain purchase price.

2. The lease term, including bargain renewal options, must be less than 75% of the economic life of the property (unless the beginning of the lease term falls within the last 25% of the estimated economic life of the property)

3. At the beginning of the lease term, the present value of the minimum lease payments (i.e., the periodic net rent payments) must be less than 90% of the fair value of the property at the inception of the lease. For example, the fair value is presumable the sale price, or $10 million. The rents are $1,100,000 per year for twenty years. For the sake of simplicity, assume that both the company’s and the purchaser’s borrowing cost is 11%. In that case, the annual rent will be discounted by 11% to a present value
of $8,759,661, or approximately 88% of the fair value ($10 million) of the property at the inception of the lease. As a result, this test will be met.

4. The company must not have a continuing involvement in the property after entering into the lease. A continuing involvement “results in the seller-lessee not transferring the risks or rewards of ownership to the buyer-lessee.” Among the several examples of a continuing involvement is an obligation or option by the company to repurchase the property even if the price is market value. Continuing involvement also includes the company’s right to participate in any of the purchaser’s future profits or appreciation in the property.

5. **RESIDUAL VALUE**

In a sale and leaseback, the residual value is transferred to the purchase from the company along with all other ownership rights in and to the property. The loss of the residual is often the most important argument against the sale-leaseback. **Our experience in similar transactions is that the residual value of a facility will typically not increase substantially over the life of the lease. In many cases there is only modest appreciation in the facility’s value over a 15 to 20 year lease term.** However as part of our analysis the residual value of the facility should be looked at as part of the company’s cost of capital. If the value of the property after twenty years grows from $10 million to $12.20 million (i.e. at a compounded rate of approximately 1% per annum) then the company loses a residual interest in the property equal to $12.2 million at the expiration of the lease term. This amount, when added to the $1,100,000 of rent payable each year, makes the company’s actual cost of capital $11.55% instead of 9.06%. (11.55% is the rate required to discount to a present value of $10 million: $1,100,000 per year for twenty years plus $12.2 million at the end of the twentieth year.) If the value of the property stays at $10 million over the twenty-year lease term, then the cost of capital is 11% (i.e. $1,100,000 per year for twenty years plus $10 million at the end of twenty years.) Only if the value of the property drops to zero after twenty years does the company’s real cost of capital equal its current cost of 9.06%.

The impact of losing the residual may be softened somewhat by allowing the company to renew the lease after the initial twenty-year term. In many cases, the company will be granted successive options to extend the lease for as long as thirty or more years with, for example, six, five-year extended terms. Nevertheless, the company will customarily have to pay rent at least equal to that payable during the initial term. Ultimately, of course, the property still reverts to the purchaser, when the lease finally expires.

6. **REINVESTMENT RATE**

The company’s reinvestment rate has to be taken into account in deciding between the two types of financing. This can be a complex analysis, but it does help complete the comparative picture.

If we assume a reinvestment rate of 14%, any financing proceeds the company receives can be reinvested in its business for an annual return of 14%. Similarly, any monies paid out to service the company’s obligations on the financing will be withdrawn from use in its business at a cost of 14% per annum.

Applying this analysis to the examples we have been using, the company is receiving $7 million under the mortgage arrangement. At a 14% reinvestment rate the $7 million will be worth approximately $96 million after twenty years. Over the same twenty-year period, the company will be paying out annually $880,600 as debt service on the mortgage (12.58% constant on $7 million), which at the 14% reinvestment rate, will cost the company about $80 million by the maturity date of the mortgage. Therefore, the company’s net return from the mortgage financing after twenty years is $16 million ($96 million minus $80 million).
Under the sale and leaseback arrangement, the company receives $10 million at an annual cost of $1,100,000 for twenty years. The $10 million grows (at 14%) over the twenty-year period to approximately $137,500,000. The twenty-year aggregate cost to the company of the rents (again, at 14% per annum) is approximately $100 million, or a difference of $37,500,000 ($137,500,000 minus $100 million).

Comparing the mortgage and lease alternatives, the company ends up, after twenty years, with a $21,500,000 advantage under the sale and leaseback transaction—the difference between the net benefit of $37,500,000 in the sale-leaseback and the net benefit of $16 million under the mortgage. This $21,500,000 advantage may go a long way to compensate the company for the loss of the residual in the property.

**SUMMARY OF CONSIDERATIONS IN DECIDING BETWEEN MORTGAGE & LEASE FINANCING:**

It is difficult to make a decision between mortgage and leasing on a purely quantifiable analysis. Certain factors will prevail under different circumstances. For example, a company heavily burdened by debt as a result of a leveraged buy-out may grasp eagerly for a lease financing, since it may not only avoid adding new debt to its balance sheet but it may use the proceeds to reduce existing debt. Alternatively, the company’s faith in the future value of its real estate may take such precedence over any other factor that mortgage financing become the inescapable choice.

**COMPARISON OF MORTGAGE VERSUS SALE-LEASEBACK FINANCING**

<table>
<thead>
<tr>
<th>Factor</th>
<th>Mortgage Financing</th>
<th>Lease Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of Capital</td>
<td>Usually Between 70% and 80% financing under a conventional non-recourse mortgage</td>
<td>Usually equal to 100% market value of the property</td>
</tr>
<tr>
<td>Current Cost of capital</td>
<td>Based on market rates and company’s credit standing</td>
<td>Usually about 1% to 1.5% below the cost of conventional mortgage financing</td>
</tr>
<tr>
<td>Tax Effect</td>
<td>No tax on the financing, Company can deduct interest on mortgage and depreciation</td>
<td>Tax on gain from sale. Company can deduct rents payable under lease in full.</td>
</tr>
<tr>
<td>Balance-Sheet</td>
<td>Mortgage is recorded as debt on Company’s balance sheet.</td>
<td>If a “true” lease the treatment of the financing will be “off-balance sheet”</td>
</tr>
<tr>
<td>Residual Value</td>
<td>At maturity of the residual value and capital appreciation will belong to the Company.</td>
<td>At the expiration of the lease term, residual value and capital appreciation will belong to the lessor (i.e. the purchaser of the property from the company).</td>
</tr>
<tr>
<td>Reinvestment</td>
<td>Company will usually have rate less capital to reinvest than under lease financing. Therefore, the higher the company’s reinvestment rate, the less attractive the mortgage alternative becomes.</td>
<td>Company will usually have more capital to reinvestment than under mortgage financing. Therefore, the higher the company’s reinvestment rate, the more attractive the leasing alternative.</td>
</tr>
</tbody>
</table>
A SUMMARY OF BOND-TYPE NET LEASES & OPERATING LEASE TESTS

There are two basic types of net lease transactions. One is the bond-type transaction, which usually involves a twenty- to twenty-five-year net lease. The other is referred to as the real estate net lease transaction, which typically has a term of between ten and fifteen years.

Under the bond-type net lease the corporate lessee assumes all of the obligations, risks, and costs of the real estate and pays the owner an absolutely net rental. What we actually have is a bond of the corporate lessee, in the form of a lease document. To understand the bond-type net lease from that perspective, consider the following example.

A corporation that has a strong, investment-grade credit rating needs a new headquarters office building. (We will call the corporation UTT.) The cost of the building is $50 million, inclusive of the land. (The land is worth about $2,500,000 or 5% of the total cost.)

If UTT buys the property, it has to come up with $50 million. Because of its financial strength, it can borrow the full $50 million directly from an insurance company or other financial institution at a 10% interest rate. If the financing is for twenty-five years and is amortized by maturity, the debt-service constant is 11.017%, requiring annual payments of $5,508,500 on $50 million.

Instead of buying, UTT decides to lease the building; an investor will acquire the property and lease it to UTT for a basic term of twenty-five years. The net annual rent will be $4,950,000 over that term instead of $5,508,500 (the debt-service payment on a direct borrowing of $50 million.) UTT will, as a result save $558,500 each year ($5,508,500 minus $4,950,000), which is close to a 10% reduction in UTT’s annual cost for the use of the building.

The annual rent of $4,950,000 reflects a borrowing cost to UTT of approximately 8.66% or 1.34% less than the 10% interest rate in the case of the direct financing. (Assuming an annual debt-service payment of $4,950,000, 8.66% is the interest rate payable on a twenty-five-year, fully amortizing loan in the principal amount of $50 million.)

The Advantages of a Bond-Type Net Lease:

The advantages to UTT of the net lease over direct borrowing are the following:

1. The cost of capital to UTT over the twenty-five-year basic term lease is 1.34% lower than in a direct financing (i.e. 8.66% instead of 10%). This results in an annual savings to UTT of $558,500.

2. The annual savings of $558,500 can be invested by UTT in its business operations. Assuming that UTT can earn 14% on its capital (i.e. reinvestment rate), its savings will total about $101,575,000 after twenty-five years.

3. The lease will be an operating lease and not a capital lease. As such, it will not have to be shown on UTT’s balance sheet either as a debt or as a long-term lease obligation.

Operating Lease Tests:

The tests of an operating lease are set forth in Paragraph 7 of Statement 13 of the Financial Accounting Standards Board (FASB 13). The UTT lease satisfies these tests for the following reasons:

1. The lease does not transfer ownership of the property to UTT by the end of the lease term. At the end of the twenty-five-year term, the investor continues to own the property.

2. The lease does not contain a bargain purchase option. In other words, UTT does not have an option to purchase the property from the investor at a below market price. (In this example, it does not have an option to buy at any price.)
3. The lease term is for a period that is less than 75% of the estimated economic life of the property.

4. At the beginning of the lease term, the present value of the minimum lease payments ($4,950,000 per year, in this example) is less than 90% of the fair value of the property to the investor at the inception of the lease.

This last test—the so-called “90% test”—is often the major stumbling block in meeting the requirements of an operating lease. A calculation must be made to determine whether UTT passes this test by having a fair market value of the building to the investor of at least $50 million. Next, the annual rents of $4,950,000 are discounted to present value by using a 10% discount rate. (The 10% rate is UTT’s direct or incremental borrowing rate.) The present value of these rents is approximately $44,930,000. Because $44,930,000 is only 89.8% of $50 million (the fair market value of the property at the inception of the lease), the 90% test is satisfied.

In making the calculations required by the 90% test, we have assumed a 10% discount rate—UTT’s direct or incremental borrowing rate. Ordinarily, this is the appropriate rate to be used for such discounting. There is an exception if (i) the investor’s (or lessor’s) “interest rate implicit in the lease” is less than the lessee’s (UTT’s) direct borrowing rate and (ii) it is practicable for the lessee (UTT) to learn the implicit rate computed by the investor. It can generally be assumed, in dealing with the 90% test, that the investor’s implicit rate will neither be known to the lessee nor ascertainable by the lessee. The investor’s implicit rate would be calculated by finding the rate necessary to discount both the net annual rents and the investor’s assumed residual value in the property to a present value (in this example, $50 million). The assumed residual value is a matter between the investor and its accountant and does not involve the lessee. Therefore, UTT is unlikely to know what residual assumption the investor is using. Thus, since the investor’s implicit rate depends, in great part, on its residual assumption, UTT is unlikely to know or be able to ascertain that implicit rate.

As discussed earlier, there are a number of other factors that UTT must consider before making a final decision as to whether to own or lease the property.

**LOSS OF RESIDUAL:**

Most important, UTT has to give up the property to the investor at the end of the lease term. If UTT had purchased the property, it would have owned it free and clear of the mortgage after twenty-five years. The loss of the property—sometimes referred to, as the loss of the residual—at the end of the lease term is the most compelling argument against the net lease arrangement financing. There are a few ways to mitigate against this loss, but there is no way to eliminate it. Among the methods are the following:

**Extended terms:** The investor will usually be willing to give the lessee the option to extend the lease term, often for as long as another twenty-five years. Then rents payable during these extended periods are ordinarily fixed at the outset of the transaction. For example, UTT may have the right to five extensions of five years each, at annual rents of $5 million. These extended terms should not affect the balance sheet treatment of the lease, as long as the rents during these terms are not at bargain rates. The right to extend costs money, however, and UTT would not have had to spend that money if it had purchased the property. At the expiration of the extended terms, UTT has to leave, and the investor has unencumbered ownership of the property.

**Purchase option:** The investor can give UTT an option to purchase the property at the time the lease term expires. For both tax and accounting reasons the option price has to be geared to the fair market value of the property. Again, however, the fact that UTT has to pay any price to take
over the ownership of the property creates a cost it would not have to assume if it were to purchase (rather than lease) the property and finance the cost.

Furthermore, a purchase option could result in adverse accounting consequences, if this were a sale and leaseback transaction—a transaction in which UTT owned the property before entering into the net lease arrangement. For example, assume that UTT was, initially, the owner of the property back from the investor. This would be a sale and leaseback transaction, and it would come within the jurisdiction of Statement 98 of the Financial Accounting Standards Board (FASB 98). Under FASB 98, UTT would have a “continuing involvement” in the property because of the purchase option. For accounting purposes, a sale would not be deemed to have occurred because of UTT’s continuing involvement. Among the consequences of this situation is that UTT could not recognize a current profit from the sale to the investor on its financial statement.

One way in which UTT might get the property back in a sale and leaseback transaction is through a right of first refusal. This right would arise if the investor wanted to sell the property to a third party. Before selling, the investor would have to give UTT the right to match the offer. The problem is that the investor may not be willing to sell to anyone, and UTT cannot force a sale. In addition, the third-party offer has to be bona fide. A sham arrangement with a third party in order to get around the purchase option restriction would violate the requirement of FASB 98. However, in the UTT example, FASB 98 does not come into play, because UTT has never owned the property, there cannot be a sale and leaseback.

**Investment of rent savings.** As shown above, UTT will make approximately $101,575,000 after twenty-five years by investing the annual rent savings of $558,500 (the difference between $5,508,500 of annual debt-service if it had taken a direct 10% loan and $4,950,000 under the net lease scenario) at it 14% reinvestment rate. This may be a reasonable hedge against the loss of the residual in the property. (The property would have to grow at an annual compound rate of about 2.88% to reach $101,575,000 after twenty-five years)

**TAX CONSEQUENCES:**

In addition to the loss of the residual, UTT may suffer adverse tax consequences. The table below assumes that UTT buys the property through a twenty-five year, $50 million mortgage financing, bearing interest at 10% per annum and fully amortizing by maturity. By contrast, UTT’s annual rent deductions (including the rent attributable to the land) will be constant—$4,950,000 per year. These deductions are worth $1,980,000 per year assuming a 40% tax rate, inclusive of federal, state, and local income taxes). Discounting the tax benefits under each arrangement at 14%—UTT reinvestment rate—the net present value of the tax benefit is:
- Approximately $15,429,749 under the direct mortgage finance arrangement.
- $13,608,396 under the net lease arrangement.

Mortgage financing gives UTT a tax advantage of $1,821,353 over leasing. This advantage narrows to the extent that the land component of the property exceeds 5% because, as land increase as a factor of cost, the annual depreciation deductions decline. The allocation between land and building is irrelevant in a net lease transaction because the lessee can deduct the full amount of the rent whether it is attributable to the land or to the building.

**TABLE A**

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<tr>
<th>Year</th>
<th>Interest Deductions</th>
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<td>$4,390,252</td>
<td>$1,756,101</td>
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<td>18</td>
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<td>$1,217,949</td>
<td>$4,156,642</td>
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<td>19</td>
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<td>$1,217,949</td>
<td>$3,899,671</td>
<td>$1,559,868</td>
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<td>20</td>
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<td>$1,217,949</td>
<td>$3,617,002</td>
<td>$1,446,801</td>
</tr>
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<td>21</td>
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<td>$3,306,067</td>
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<td>22</td>
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<td>$2,964,039</td>
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<td>23</td>
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<td>$2,587,807</td>
<td>$1,035,123</td>
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<td>24</td>
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<td>$1,217,949</td>
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<td>$869,581</td>
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<td>$500,764</td>
<td>$1,217,949</td>
<td>$1,718,713</td>
<td>$687,485</td>
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</tbody>
</table>

**Notes**

1. Assumes 95% of the property (or $47,500,000) can be depreciated over thirty-nine years, at the rate of $1,217,949 per year. (The $2,500,000 balance is land.)
2. Assumes UTT’s tax rate is 40% (inclusive of federal, state, and local income tax).

**INVESTOR’S RETURN:**

UTT is able to get a lower current cost of capital with a net lease than with a direct financing because an investor is usually willing to accept a lower current cash return on its money than a lender would. The investor is compensated for this apparent sacrifice through favorable tax treatment and by the residual value in the property.

If the investor is a regular or subchapter C corporation (and is not closely held), it can take full advantage of the deduction from the property. The passive activity rules do not apply to regular corporations. As a result, tax benefits—in particular, interest and depreciation—have current value to the investor.

Let’s make a few assumptions about residual value:

- The property’s growth rate is 3% per year, so that after 25-years it will be worth about $105 million.
- The value of the property stays at $50 million.
- The value of the property drops by 35% to $32,500,000

Taking each of these assumptions into account, an investor—a subchapter C corporation—buys the building for $50 million. It puts up $10 million in cash, and finances the remaining $40 million through a mortgage loan. The terms of the mortgage financing are the same as those UTT could obtain—a 10% interest rate twenty-five year maturity, and 100% amortization (The
investor should have no problem getting these mortgage terms, because the financing will be based on the credit of UTT and the $4,950,000 of rents UTT pays each year.) Based on these facts and assumptions, the investor’s position is set forth below. The rate of return to the investor or a $10 million cash investment is as follows:

- If the residual value is $105 million: 10.38% after-tax.
- If the residual value is $50 million: 7.99% after-tax.
- If the residual value is $32.5 million: 6.57% after tax

A OVERVIEW OF FASB NUMBER 13

Basic Premises:
The rents in a net lease transaction do not amortize investments in full over the basic lease term. Investors rely upon residual value for a significant part of its return on investment. Accordingly, the investor takes a substantial residual risk. This, in turn, achieves one of the major objectives of FASB Number 13 – namely the lessor to have a material stake in residual values in order for the lessee to account for the lease as an operating lease.

The Present Value Requirement:
In order for the lease to be an operating lease, the “present value at the beginning of the lease term of the minimum lease payments – {must be less than} 90% percent of…the fair market value of the leased property to the Lessor (emphasis added) at the inception of the lease”. There are three tests that can be used to determine whether or not the below 90% requirement has been met. If any one of these tests is met, then the requirement will be satisfied.

Definition of Present Value:
In calculating the present value of the minimum lease payments, the discount rate to be used has to be the lessor of (i) the Lessor’s implicit rate (if practicable for the Lessee to learn) or (ii) the Lessee’s incremental borrowing rate.

A Misconception in the Calculation of the Discount Rate:
In determining the discount rate, there is a frequently applied misconception—that the Lessor’s implicit rate is the rate at which the rents discount back to present value. For example, assume (i) a $10 million property, (ii) a 20-year lease and (iii) an annual rent of $900,000. By discounting the rent by 6.39%, you get a present value of $10 million – equal to the property cost. Obviously, the 6.39% is not the implicit rate used by the Lessor, and it is highly unlikely it is even close to the Lessee’s incremental borrowing rate. In fact, the 6.39% has, in itself, no meaning. It is only a mathematical calculation, which tells you that, if you had no source of return other than the rent, your return would be 6.39%. But, as will be discussed below, the Lessor does have another source or return—the residual value—which will supplement its return.

Test Number One—the Lessee’s Incremental Borrowing Rate:
This is defined as the “rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset.” (For the purpose of this analysis, it is assumed that we do not know the Lessee’s incremental borrowing rate.) This assumption is reasonable not only for us, but it is more than likely that the Lessee, itself, does not know its incremental borrowing rate.

In determining the Lessee’s incremental borrowing rate, a number of factors should be taken into account:

- Liquidity of the financing.
- Directness of the obligation to the lease.
- Amount of the financing in relation to the value of the collateral.
- Financial covenants.
- Adjustments in the periodic payments.
- Borrowing capacity of the lease.
- Interest rates on the Lessee’s other debt.

Assume that the Lessee’s direct borrowing rate is 9% if the debt is (i) a direct obligation of the Lessee, (ii) liquid, (iii) contains financial covenants and (iv) over-collateralized (i.e. 75% debt to total value). In that case, we believe the reasonable discount (or incremental borrowing) rate to be used in calculating present value is a net lease transaction should be up to 100 to 150 basis points higher than the direct borrowing rate. This is due to the fact that the financing has (i) no liquidity, (ii) is an indirect obligation of the Lessee, (iii) is 100% financing, (iv) usually has no financial covenants and (v) provides for fixed rent payments (without adjustment).

Assume, for example, the annual rents in a 25-year transaction are $19,900,000 on a $200 million portfolio of properties (which we assume reflect market rents and value). If the Lessee could borrow directly up to 75% to 80% of the $200 million at 9.20%, then they would use a discount rate of 10.20%. At that rate, the present value of the rents would be approximately $177,900,000—or 88.94% of the price paid by the Lessor to the Lessee for the properties. As a result, the rents do not fully amortize the $200 million dollar investment. They amortize only $177,900,000 of the investment; hence the investor has to look to the residuals for the balance of its return.

Test Number Two—Actual Cost:
As discussed above, the fair value of the property to be used in calculating whether the present value of the rents is less than 90% is the fair value to the Lessor. Leaving aside residual values for the moment, it is clear that the value to the Lessor has to include its costs of acquisition over and above the purchase price paid directly to the Lessee.

If, for example, the total cost is (i) the $200 million payable to Lessee plus (ii) 4% of additional acquisition costs (i.e. $8 million), including, brokerage, consulting, legal, and other professional fees, and other closing costs. These costs are not reimbursed or indirectly by Lessee and are not incurred to implement the lease. Therefore the total cost is $208 million (and represents what fair market value would be in an arms-length transaction). It is the irreducible minimum at which the Lessor would, or could afford to, sell the properties to an independent third party in an arms-length transaction.

Since the fair value of the properties to the Lessor is $208 million, then the present value of the rents has to be less than $187,200,000 for the lease to be an operating lease. The discount rate to be used to reach $187,200,000 is 9.54% (or 34 basis points above the Lessee’s purported 9.20% direct debt rate.) Therefore, so long as the Lessee’s incremental borrowing rate is 9.54% or higher, we will pass this test.

Test Number Three—Residual Valuation:
The fair value of a property should be based upon two factors: (i) the present value of the rent stream during the basic lease term plus (ii) the present value of the estimated residual value. Assume, for the sake of illustration, that the present value of the Lessee’s rent stream ($19,900,000 per year) is $200 million. Also assume that the estimated residual values are equal to the Lessor’s direct cost of $208 million. The present value of the residual positions will depend upon the discount rate applied. Set forth below is a range of discount rates.
<table>
<thead>
<tr>
<th>Rate Value</th>
<th>Residual Value</th>
<th>Total Property Value (including rent stream)</th>
<th>89.9% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>12.50%</td>
<td>$10,945,870</td>
<td>$210,945,870</td>
<td>$189,640,000</td>
</tr>
<tr>
<td>15.00%</td>
<td>$6,319,000</td>
<td>$206,319,000</td>
<td>$185,480,375</td>
</tr>
<tr>
<td>17.50%</td>
<td>$3,691,000</td>
<td>$203,691,000</td>
<td>$183,118,209</td>
</tr>
</tbody>
</table>

Based upon these values, the Lessee’s incremental rate required to discount the rents to 89.9% of the total value will be as follows:

<table>
<thead>
<tr>
<th>89.9% of Total Value</th>
<th>Lessee’s Incremental Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$196,292,000</td>
<td>8.95%</td>
</tr>
<tr>
<td>$189,640,000</td>
<td>9.38%</td>
</tr>
<tr>
<td>$185,480,375</td>
<td>9.66%</td>
</tr>
<tr>
<td>$183,118,209</td>
<td>9.82%</td>
</tr>
</tbody>
</table>

In applying Test Number Three to sale and leaseback transactions, it is important to bear in mind paragraph 33-1 of the Arthur Andersen Greenbook.

Under 33-1, if the fair value of a property in a sale and leaseback transaction is “clearly more than the sale price”, then the difference between the fair value and sale price is effectively treated as additional rent payable by the Lessee. We agree with this treatment. However, we do not believe it applies to sale and leaseback transactions.

Paragraph 33-1 deals with the situation in which the Seller-Lessee is clearly selling the property for less than market value. Among its motivations may be to reduce its taxable profit as well as reduce the rentals. In those situations the Seller-Lessee is actually prepaying rents by accepting less than fair market value for the property.

This will not be the situation when a Lessor acquires a property from the Seller-Lessee, the purchase price will be fair market value to the Seller-Lessee based upon an arms-length negotiation. However, at the inception of the lease, a Lessor will have added a significant increment of value over and above fair market value paid to the Seller-Lessee. Listed below are some of the elements of value added by the investor’s involvement (none of which reduce the price paid to the Seller-Lessee by the Lessor below fair value). A Lessor has been able to obtain this increment of value only by assuming risk or expending money (over and above the amount paid to the Seller-Lessee).

1. As discussed under Test Number Two, the Lessor has had to incur costs, including legal and other transaction expenses, in order to structure a transaction suitable for investment. These costs will also be for the benefit of any subsequent buyer (which buyer may not have to incur similar expenses since they have already been incurred by the primary Lessor).
2. The Lessor will add value for itself and any subsequent purchaser through favorable (and, in many cases, below market) financing of the transaction. If the Lessor is able to obtain such financing because it is prepared to take the “warehousing” risk before the transaction is securitized through a conduit or other similar program.
3. The Lessor assumes and retains a significant residual risk, since the net rents will not enable the Lessor to recover fully its investment in the property.

The fact is that the Lessor does add value. As a result, at the inception of the lease, the fair value of the property to the Lessor is, and should be, more than the price paid to the Seller-Lessee. This does not mean that the Seller-Lessee has received less than fair value for the property. The
Lessor’s position in a sale-leaseback or any other net lease transaction is analogous to a developer. The developer may be acquiring all paint, bricks, mortar, pipes and other property components at fair value. Nevertheless, through the developer’s expenditures and assumption of risk, the fair value of the property will be greater than the sum of all these various components.

In conclusion, it is almost certain at least one of the three tests will be met in a sale-leaseback structured net lease transaction. In most cases, all three of the tests will be met. Accordingly, based upon the below 90% requirement, the Seller-Lessee’s net leases should qualify as operating leases.

AN OVERVIEW OF THE STRUCTURED FINANCE LEASE

<table>
<thead>
<tr>
<th>Lease Terms &amp; Conditions</th>
<th>Conventional Real Estate Lease</th>
<th>Structured Finance Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed rate renewals</td>
<td>Fair market value</td>
<td>Lower of 60-90% of average base term rental, or FMV</td>
</tr>
<tr>
<td>Maintenance &amp; Repair</td>
<td>Landlord responsible for roof and building structure</td>
<td>Tenant responsible for building</td>
</tr>
<tr>
<td>Casualty &amp; Condemnation</td>
<td>Lease cancellation in case of Based on severe casualty or condemnation</td>
<td>Rights to purchase stipulated loss values.</td>
</tr>
<tr>
<td>Alterations &amp; Improvements</td>
<td>Subject to Landlord’s approval</td>
<td>Not subject to Landlord’s approval.</td>
</tr>
<tr>
<td>Indemnities</td>
<td>Landlord and Tenant provide Indemnification.</td>
<td>Tenant provides general indemnification and limited tax indemnity.</td>
</tr>
<tr>
<td>Rights to terminate</td>
<td>None</td>
<td>Tenant has such rights.</td>
</tr>
<tr>
<td>Lease for obsolescence or because surplus</td>
<td>Subject to Landlord’s approvals</td>
<td>Tenant controls</td>
</tr>
<tr>
<td>Assignment &amp; Subletting</td>
<td>Permitted</td>
<td>Not permitted</td>
</tr>
<tr>
<td>Rent set-offs</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

A COMPARATIVE ANALYSIS OF CAPITAL VS. OPERATING LEASE STRUCTURES

We have a great deal of experience in structuring all types of off-balance sheet lease structures and have completed financing transactions for a significant number of corporate and automotive clients. Enclosing you will find a quick overview of operating lease structures as well as a detailed summary of a standard synthetic leases structure.

When setting up a Sale/Leaseback transaction and/or a new lease transaction there are four basic criteria, which should be evaluated to determine if the transaction in question qualifies as an operating lease. These four criteria are as follows:

1. Automatic transfer of title at the end of the lease term.
2. A bargain purchase option is present in the lease.
3. The lease term equals or exceeds 75% of remaining estimated economic life of the asset.
4. The present value of the minimum future lease payments equals or exceeds 90% of the excess of the fair value of the property over the retained ITC, if any? (The 90% Test)
If any of these criteria are met the lease does not qualify as an operating lease. In addition to the above noted criteria there are other items that are “indicators” of capital leases. Each of these indicators by themselves may be present in an operating lease, but as the number of these items increases the likelihood of the lease being a capital lease increases. These “indicators” include:

1. A leveraged lease where the debt is non-recourse to the Lessor.
2. Lessee’s guarantees the Lessor’s debt.
3. Lessee asserting property ownership for tax purposes, as is the case in the traditional “Synthetic Lease”.
4. An open-ended lease.
5. Lessor is related to the Lessee.
6. The Lessor entity is a “dummy” entity (without independent economic substance), as is the case with most “Synthetic” lease transactions.
7. The Lessor’s debt is secured by leased property with debt service requirements that match the lease rental payments.
8. The lease contains “Hell or High Water” terms.
9. The Lessee owns the land on which the leased building is situated.
10. There are purchase options in the lease which correspond with the unamortized lease balance
11. The leased property is constructed to the Lessee’s specifications or the lease property is expected to be used only by the Lessee during its useful life.
12. The lease contains fixed price purchase options.
13. The Lessor has fixed price put options.
14. The Lessee guarantees the residual value of the property.

These items can be present in any lease, including operating leases. So if the lease transaction is carefully structured in cooperation with the Lessee’s accountants the desired operating lease treatment can be achieved while still passing through the benefits of the underlying debt.

The author, Timothy J. Morris, SIOR, CCIM has represented a significant number of companies in real estate and development for 15 years totaling in excess of $650 million. He has been a strong proponent of using the program management integration approach to handling Corporate Real Estate projects. He holds a B. S. degree in Science and Engineering from the United States Military Academy, West Point, New York and an MBA, in finance from Boston University’s Frankfurt, Germany campus.

Corvus International, headquartered in Bloomfield Hills, Michigan, is a real estate representation, program management and fee-based development firm committed solely to the objective representation of Tenants and Corporate Users. Corvus International’s mission is to reduce all facility and real estate related costs of its clients while increasing workplace effectiveness and quality. Corvus has 15 offices in the United States, Mexico, South America, Europe, and Asia, and currently manages projects in excess of $250 million annually in projects.