

IS NOW A GOOD TIME FOR SALE AND LEASEBACK OF COMMERCIAL REAL ESTATE?

Submitted by: Martin H. Abo, CPA/ABV/CVA/CFF

May 29, 2020

With COVID-19 affecting so many businesses many may be looking at their real estate holdings to see if they should entertain a sale-leaseback transaction with a nonprofit real estate foundation for a particular property to free-up cash tied up in their real estate. For mission critical buildings that are being leased from non-profit or for-profit landlords, they may consider negotiating with the property's owner for a sale-leaseback with a nonprofit real estate foundation, attempting to reduce rent expense. A nonprofit real estate foundation is a third-party nonprofit entity that sources low-cost capital to acquire or develop properties used by hospitals in furtherance of their charitable mission. The sale-leaseback option for so monetizing these non-core assets will work as well with traditional sources like insurance companies, REITs and other institutional investors.

Confer with the professionals at WCRE or ask us for a seasoned real estate or tax attorney but here's one technique Abo has seen work well with business clients. Although real estate is generally thought of as an illiquid asset, some liquidity can be achieved by taking out a loan backed by the property. Alternatively, a sale and leaseback may be used effectively if a company's balance sheet is burdened with excessive debt or just having difficulty in obtaining new capital. Typically, the transaction involves the company owned property being sold to a third party and then leased back to the company under a long-term lease.

Sale and leaseback transactions may be on the rise but clients need to be aware that the IRS often focuses on transactions between closely-held corporations and their controlling shareholder to make sure that these transactions benefit the company as well as the shareholder. In one common type of sale and leaseback transaction, the company sells the land with a building on it to the shareholder and, in turn, the shareholder leases it back to the company. Some of the financial and tax benefits we've seen have included:

- ▶ The rental deductions the company could take might be significantly larger than the former depreciation deductions if the property had been in service for many years.
- ▶ After the sale and the leaseback transaction, the shareholder's basis in the property will be its fair market value which is usually greater than the price paid for the property by the corporation. Thus, the shareholder's depreciation deduction would be much greater than what was previously available to the corporation (also still need to consider the tax consequences of the sale to the corporation).
- ▶ The sale and leaseback may enable the shareholder to generate passive rental income that could be offset against passive losses of the shareholder.

The IRS would obviously be concerned that these transactions have economic substance and that they are based on reasonable market conditions, and not just designed to generate larger tax deductions. Thus, for a sale to be valid, the controlling shareholder should have taken an equity interest in the property and also assumed the risk of loss. For the leaseback to be valid, four tests come to mind that really should be met:

1. The useful life of the property should exceed the term of the lease.

“Building Successful Relationships” is our Mission.

The foregoing information was furnished to us by sources which we deem to be reliable, but no warranty or representation is made as to the accuracy thereof. Subject to correction of errors, omissions, change of price, prior sale or withdrawal from market without notice. This article is for informational purposes only. © 2018 WCRE All Rights Reserved

2. Repurchase of the property by the corporation at the end of the lease term should be at fair market value and not at a discount.
3. If the leaseback allows for renewal, the rate should be at a fair rental value (speak to WCRE, not necessarily the accountant).
4. The shareholder should have a reasonable expectation that he or she will generate a profit from the sale and leaseback transaction based on the value of the property when it is eventually sold and the rental obtained during the lease term.

I suspect one of the biggest risks for the seller-lessee is the loss of a valuable asset that could have substantially appreciated over its useful life. Also, the rental market could drop, leaving the seller locked into a rental rate in excess of fair value. On the other side of the table, the seller could move or default, leaving the buyer with unattractive real estate in a soft market.

Even if there are no other problems, the benefits of the deal could be substantially reduced if the IRS deems that it is merely a “financial lease.” In that case, the IRS will treat the seller-lessee as the true owner of the real estate, with all the appropriate tax assessed, and the buyer-lessor will be treated as a lender-mortgagee.

Since sale and leaseback transactions can be quite complicated and also have to pass IRS muster, as I stated earlier, whether you are a buyer, seller or investor, you are well advised to consult with WCRE and seasoned real estate/tax counsel about your financial and tax consequences and the manner of structuring and implementing them to withstand possible IRS challenge.

FOR MORE INFORMATION:

Martin H. Abo, CPA/ABV/CVA/CFF is a principle of Abo and Company, LLC and its affiliate, Abo Cipolla Financial Forensics, LLC, Certified Public Accountants - Litigation and Forensic Accountants. With offices in Mount Laurel, NJ and Morrisville, PA, tips like the above can also be accessed by going to the firm’s website at www.aboandcompany.com.

For more information, contact:



Martin H. Abo, CPA/ABV/CVA/CFF
307 Fellowship Road, Suite 202
Mt. Laurel, NJ 08054
(856) 222-4723

marty@aboandcompany.com



“Building Successful Relationships” is our Mission.

The foregoing information was furnished to us by sources which we deem to be reliable, but no warranty or representation is made as to the accuracy thereof. Subject to correction of errors, omissions, change of price, prior sale or withdrawal from market without notice. This article is for informational purposes only. © 2018 WCRE All Rights Reserved