

Implications of Sale-Leaseback Transactions

Background

A sale-leaseback occurs when one party sells property to a buyer, who then leases the property back to the seller. Although this arrangement occurs in a single transaction, it creates a relationship between the seller/tenant and buyer/landlord that extends beyond the initial sale of the property. Parties should craft sale-leaseback transactions with the tax implications and future relationships in mind.

Tax Implications

A. Benefits of a Sale-Leaseback Transaction

1. Tax Benefits for Seller/Tenant – tenants may deduct “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. (26 U.S.C. § 162 (a)(3) (2012)).
2. Tax Benefits for Buyer/Landlord – buyer/landlord can take a depreciation deduction, and if the property is financed, the buyer/landlord may be able to deduct the loan’s interest. (26 U.S.C. §§ 163, 167, 168 (2012)).
3. Liquidity – seller/tenant can put cash from the purchase price toward other investments
4. Value & Rate of Return – buyer/landlord can add investment property to its portfolio that generally performs at a predictable, high rate of return
5. Financing – parties have freedom to structure financing and options to purchase or extend

B. Drawbacks of a Sale-Leaseback Transaction

1. Disqualified Transaction – the IRS may interpret the sale-leaseback transaction as an attempt to avoid federal income tax. In such a case, the seller/tenant will have to evaluate taxable income based on the constant rental accrual rate of the property.
2. Like-kind Exchange – parties cannot recognize a gain or loss a transaction involving the exchange of a lease in real estate for 30 years or more for a fee interest in real estate. (26 U.S.C. § 1031(a); 26 C.F.R. 1.103 (2018)).
3. Financing Transaction – the IRS may find that the buyer/landlord is actually making a loan to the seller/tenant, and therefore prohibits the seller/tenant from taking rental deductions, prohibits the buyer/landlord from reporting income in the form of rental payments, and reallocates the depreciation deduction to the seller/tenant. (*See, e.g., Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939)).
4. Double Transfer Taxation – parties may be required to pay transfer tax on the sale of property and on the subsequent leasehold interest. (20 N.Y.C.R.R. § 575.7 (2018)).

C. Avoiding Problems with a Sale-Leaseback Transaction: Economic Substance

Depending on how the parties structure the sale-leaseback transaction, the IRS and/or the courts may require the parties to forgo important tax deductions. If so, neither party may receive the benefit of its bargain.

The IRS and the courts typically view sale-leaseback transactions as a whole, rather than simply considering the form of the transaction. Therefore, parties structuring a sale-leaseback transaction should do so carefully to avoid unintended tax consequences. If a transaction is an arms-length transaction, is “not shaped solely by tax-avoidance features that have meaningless labels attached,” and the “lessor retains significant and genuine attributes of traditional lessor status,” the IRS or court may find that the transaction has sufficient economic substance. (*Frank Lyon Co. v. U.S.*, 435 U.S. 561, 583–84 (1978)). The parties should ensure that the purpose of the transaction extends beyond simply avoiding paying higher income taxes on the property.

Protecting the Parties’ Relationship

A. Loss of Flexibility

The seller’s relationship with the property changes significantly upon the sale and subsequent lease of the property, as the seller/tenant loses some aspects of control. The buyer/landlord may impose restrictions or covenants on the land that the seller/tenant must follow. Additionally, the parties should consider either party’s rights with respect to terminating, assigning, or subletting the lease, and whether the seller/tenant has an option to purchase the property or extend the lease upon expiration of the lease term.

B. Classification of Lease

The seller/tenant and buyer/landlord typically enter into triple net leases, where the seller/tenant pays property taxes, insurance, and maintains the property. As investment property, the buyer/landlord has an interest in the property’s upkeep. The parties should agree on the scope of these responsibilities before entering into the lease.

C. Seller/Tenant’s Interest

Because an option to purchase as part of the sale-leaseback may trigger unintended tax consequences, the seller/tenant may not have an ownership interest at the end of the lease term. To protect its interest, the seller/tenant should plan in advance whether it plans to purchase the property for fair market value, extend the lease, or relocate to different premises upon expiration of the lease.

D. Buyer/Landlord's Bankruptcy

If the buyer/landlord files for bankruptcy, the seller/tenant may lose any rights it had to extend the lease or purchase the property. The seller/tenant may have some protections under bankruptcy law.

Conclusion

Parties considering a sale-leaseback transaction should carefully evaluate the transaction's benefits and drawbacks. A transaction structured with economic substance and evidence of some purpose beyond simply avoiding federal income taxation lowers each party's risk. Furthermore, negotiating the scope of the seller/tenant and buyer/landlord relationship before entering into the transaction reduces the likelihood of complications between the parties in the future.