

Utilization of the Sale and Leaseback Transaction

By: *Garland W. Binns, Jr.*

The sale and leaseback transaction involves the sale of a fixed asset to an investor, with the fixed asset being leased back to the seller. Fixed assets in a sale and leaseback transaction may include equipment and improved real estate. This article will focus more on the area of sale and leaseback transactions relating to improved real estate.

There are benefits to both parties in a sale and leaseback transaction. The seller receives the proceeds of the fair market value of the property and still retains the use of the property, while at the same time the investor receives the tax benefit of depreciation and a guaranteed long term lease of the property. A sale and leaseback transaction will also improve a seller's financial ratios and reduce depreciation expense.

A sale and leaseback lease agreement will generally be for a period of at least 15 years with renewal options. The terms of the lease agreement will include a base amount of rent with increases or decreases in the rental amount based on such factors as changes in the Consumer Price Index. The base rate of rent will depend upon a number of factors, such as the general market conditions for the property and the financial strength of the seller as the lessee of the property. The lease payments are typically fixed to provide for amortization of the purchase price over the term of the lease, plus a specified return rate to the investor. Because a sale and leaseback transaction is not considered a loan, state usury laws do not apply. Generally, the lease agreement between the parties will be characterized as a triple net lease, meaning that the seller, as the lessee, will be responsible for all costs including insurance, taxes and maintenance.

In structuring a sale and leaseback transaction, it is important to make sure that the purchase price of the property is at fair market value. In this regard, as

part of the transaction, the purchase price will be based on one or more appraisals as to the market value of the property. If the lease agreement contains a right of first refusal or option by the seller to purchase the property from the investor, it is important to make sure that this right of first refusal or option to purchase is premised on the fair market value at the time of this subsequent event.

In a sale and leaseback transaction the seller, as lessee, must comply with the accounting requirements of Financial Accounting Standards Board Statement No. 98 ("FASB Statement No. 98"). FASB Statement No. 98 does not permit a seller to have any continuing involvement in the transaction other than as a lessee. Under FASB Statement No. 98, lessee's continuing involvement would include, but not be limited to factors such as the seller being obligated for guaranteeing a portion of the investor's debt or seller making an equity investment in the investor.

In addition to the seller complying with the accounting requirements, the parties to a sale and leaseback transaction will want to be sure that the transaction complies with the technical requirements of the Internal Revenue Code. The landmark case dealing with the tax issues in a sale and leaseback transaction is *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). In this case, the Court looked at the economic realities of a transaction, rather than the particular form the parties employed. The Court evaluated the substance of the facts to determine that it should be treated as a sale and leaseback transaction, rather than a financing transaction, concluding that the transaction had genuine economic substance and was not shaped solely for tax avoidance. The Court pointed out that a sale and leaseback transaction will not be upheld unless the investor, as lessor, acquires and retains significant and genuine attributes of a traditional owner including bearing the risk of the lessee's nonpayment of rent. The investor's return was dependent on the property's value and the investor's equity investment was at risk if the property declined in value. The Court noted that the economic burden of any decline in the value of the property is integral to the determination of owner-

ship for tax purposes.

Factors to consider before entering into a sale and leaseback transaction include:

- loss of depreciation by the seller;
- seller's expense of leasing the property on a long term basis;
- possible negotiation of a substitute property clause in the sale agreement in the event the seller discontinues use of the property in the future;
- income to be generated from the proceeds of the sale of the property;
- income derived from the capital gain, which gain is generally amortized over the life of the lease; and
- a built-in-gains tax on a Subchapter S corporation whenever an asset which has an unrealized gain at the date of conversion is sold during the ten-year period following the conversion from a C corporation.

When properly structured, the sale and leaseback transaction provides the seller with an excellent opportunity for increasing capital, funding acquisitions and stock repurchases, and providing funds for internal growth while at the same time providing the investor with tax benefits and a guaranteed return on its investment. Our firm is available to answer questions on the benefits of a sale and leaseback transaction and the utilization of an investor for accomplishing the goals to be derived from the transaction.

Consolidation In Banking

The banking industry continues to consolidate throughout the United States. Consolidation occurs from a number of factors, with banks experiencing loan portfolio problems resulting in inadequate capital on one hand and the pricing of banks in acquisition transactions on the other hand.

Recent published reports reveal that the average price on transactions in the first six months of this year had a price/book multiple of 2.38 and a price/earnings ratio of 27.17, as compared to transactions announced in the first six months of 2006, which had a price/book multiple of 2.35 and a price/earnings ratio of 25.87. The consolidation in banking continues, with the Federal Deposit Insurance Corporation reporting the number of insured institutions having declined over 40% since 1992.

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TAX

NATIONAL CPA/IRS TAX ISSUES MEETING

By: John Chism,
Taxation Committee Chairman

It was my privilege to represent the ASCPA at the national CPA/IRS Tax Issues Meeting on Wednesday, November 7th at the JW Marriott Hotel in Washington, D.C. Most of the speakers were IRS national officials. There were sessions on the following:

SMALL BUSINESS/SELF-EMPLOYED DIVISION, Speaker, Kathy K. Petronchak, Commissioner;

LARGE & MID-SIZE BUSINESS DIVISION, Speaker Frank Y. Ng, Commissioner;

WAGE & INVESTMENT DIVISION, Speaker, Richard Morgante, Commissioner;

LUNCHEON SPEAKER, Sarah Hall Ingram, Chief, Appeals;

OFFICE OF ELECTRONIC TAX ADMINISTRATION, Speaker, David R. Williams, Director;

PANEL DISCUSSION ON PREPARER PENALTIES, Various IRS officials & CPAs;

CRIMINAL INVESTIGATION, Speaker, Dawn Mertz, Senior Analyst;

TAXPAYER ADVOCATE PROGRAM, Speaker, Nina E. Olson, National Taxpayer Advocate.

The Small Business & Self-Employed Division has responsibility for businesses with assets up to \$10 million, which I'm satisfied encompasses the vast majority of clients of members of the ASCPA. Strong focus was on the tax gap, along with programs and policies they are following to help improve compliance. They estimated the tax gap for the year 2001 to be approximately \$345 billion and that 44% of the tax gap was from small business under-reporting and 80% of small businesses used paid preparers. They need the partnership and support of the CPA profession in helping to improve compliance with tax laws. They presented statistics to show that the satisfaction with their administration of the tax laws has been improving among taxpayers and tax professionals from 2003 through 2006.

The speaker in the Wage & Investment Division told of some interesting cases of attempted fraud in

the telephone tax credit refund area. He mentioned the split refund option where refunds could be directed to checking or savings accounts. This program was to encourage taxpayers to start savings accounts.

It was reported by the Electronic Tax speaker that 58% of tax returns filed in 2006 were e-filers and that percentage continues to grow. The goal for 2010 to 2020 will be 80% of tax returns by e-file.

The Panel on Preparer Penalties discussed the new standards for imposing penalties and the appeals available to the preparers.

Sarah Hall Ingram, Chief of Appeals, explained and gave a detailed outline on the appeals process available to taxpayers.

The Criminal Investigation Division, which primarily focuses on violation of federal tax law, has one of the highest conviction rates in federal law enforcement. The conviction rate is above 90% since its inception in 1919. The Division focuses on a high publicity rate for tax fraud convictions because statistics have shown tax enforcement has a strong impact on improving taxpayer compliance. The publicity rate in 2007 was at an all time high of 79.7%.

In summary, the IRS present focus is strongly on closing the tax gap. CPAs need to continue in our efforts to encourage our clients and others to comply with tax laws.

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About the Editor

Garland W. Binns, Jr. is an attorney with the firm of Dover Dixon Home PLLC in Little Rock, Arkansas. He practices with an emphasis on corporate, commercial, banking, mergers, acquisitions, divestitures, complex banking products, bank holding company formations, de novo bank formations, and securities matters. Mr. Binns is available to meet with your organization or group relating to shareholder issues, increasing capital, regulatory and compliance, areas of profitability, marketing and management responsibilities. He is a frequent speaker on matters regarding mergers,

acquisitions, commercial law, securities and banking law. Prior to entering the private practice of law, Mr. Binns was an accountant practicing with an emphasis on securities regulation and regulatory compliance. He has extensive experience representing organizations before federal and state banking and securities agencies. In addition to his business accomplishments, Mr. Binns is the 46th person in the world to be certified by the 50 States Marathon Club, a nonprofit organization dedicated to the promotion of health and fitness, as having run a marathon (26.2 miles) in each of the 50 states in the United States.

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