

Sales-Leasebacks: Benefits and Challenges For Both Healthy and Underperforming Companies

As any finance executive can tell you, turning a profit is good, but turning a profit for financial statement purposes while trimming or even eliminating it for tax purposes is even better. That statement is particularly poignant today, when CFOs are negotiating their way through a weakening economy. But even as they search for new ways to generate revenue and conserve capital, CFOs from a variety of industries are discovering the value of one strategy—sale-leasebacks—that for many years was primarily focused on real estate transactions.

Sale-Leaseback, an Alternative to Cash-Flow Based Financing

Sale-leasebacks are generally structured to unlock the equity a business has in its assets (like machinery and equipment), converting that equity into cash. Generally, a company accomplishes this by conveying the title to its assets—at their then fair market value—to a financial institution in exchange for a lump-sum payment. The new owner then leases the equipment back to the original company.

For years, even as the volume of sale-leasebacks and other forms of asset-based lending jumped (bounding from some \$100 trillion of value in 1993 to almost \$350 trillion in 2000, according to the Commercial Finance Association, an industry trade group) the strategy was primarily associated with underperforming companies and others that could not qualify for traditional, cash-flow based bank financing. Increasingly though, as CFOs and other professionals recognize the tax benefits and balance sheet enhancements afforded by sale-leasebacks, even healthy, cash-rich companies are embracing the concept. And as Wharton faculty member Edward B. Kostin notes, the flexibility of sale-leasebacks adds to their attraction.

“Leasing transactions—sometimes referred to as a financial product transaction—are used to finance business growth or troubled-company restructuring, as an alternative to other types of financing, to achieve certain results,” says Kostin, who works with the university’s Accounting department. “From a tax perspective a sale-leaseback offers the possibility of structuring the transaction as a taxable sale (which can be offset by net operating losses that may otherwise expire, unused, for tax purposes). It also offers the potential for changing the definition of which company is the ‘owner’ for tax purposes and therefore entitled to the depreciation benefits.”

John McAuliffe, a major transaction manager with GE Commercial Equipment Financing, which has structured many of these transactions, adds that, “Selling selected assets to a financial organization and then leasing them back enables a lessee to monetize items like machinery, transportation equipment and other commercial and industrial equipment. It may also offer unique economic or tax

benefits, for companies that have been unable to utilize net operating loss carry forwards for federal income tax purposes; as well as companies that are in an Alternative Minimum Tax situation—since lease payments are not considered preference items.”

Tax Considerations, Cash Flow Considerations

According to John Gamber, a vice president and region manager with GE Commercial Equipment Financing, some of these issues were behind the strategy of a Northeast-based Fortune 500 manufacturing corporation that recently sold off one of its large divisions.

“In the early stages of the negotiations, it looked like the transaction would result in a gain, for tax purposes, in excess of \$10 million for the seller,” says Gamber. “But the CFO wanted to see if there was a creative way to shelter at least a portion of the gain.”

The task was complicated by the fact that any solution had to consider the manufacturer’s Alternative Minimum Tax concerns, which were significant due to the capital-intensive nature of the company.

“During discussions with GE Commercial Equipment Financing, it was noted that a separate division within the manufacturing company operated in a technologically sensitive segment of the industry—and much of the equipment on the division’s books had a fair market value that was significantly lower than the then-current depreciated book value,” notes Gamber. “Our team advised the company to sell the technologically sensitive equipment to GE for its then fair market value of \$20 million through a sale-leaseback, creating a significant book and tax loss. This loss served to offset the gain realized by the sale within the sister division, and it also smoothed out the book income for the period.”

Gamber adds that this example is unique, “because usually, a company enters into a sale-leaseback to create a gain, not a loss (or to create cash liquidity). In this instance, though, the company accelerated a potential loss on the ultimate disposal of the equipment and positioned itself to suffer no adverse economic impact later, when the equipment becomes surplus to the lessee’s needs.”

In addition to the potential tax benefits, a sale-leaseback—unlike purchase money and other forms of financing—may offer other attractions. For example it can enable a company to choose the optimum mix of existing assets and term combination in order to obtain the best economic package and accounting treatment. “Additionally, if a sale-leaseback is structured so it is accounted for as an operating lease, it may enhance such financial ratios as debt/equity, working capital, cash, return on capital and return on assets,” adds McAuliffe.

Unique Benefits, Unique Challenges

Despite a sale-leaseback's many benefits, CFOs should be aware that a sale-leaseback agreement can present unique challenges.

"Evaluating a sale-leaseback requires an understanding of the income tax and financial statement positions and objectives of the parties (lessor and lessee) and how the parties might be affected by a proposed transaction, and then modifying the proposed structure to achieve the desired results," cautions Wharton's Kostin. "It is not always obvious which party is the 'owner' for tax and financial statement purposes. Because tax and financial statement rules are not coincident, an arrangement might be structured so that one party is an 'owner' for income tax purposes but not an 'owner' for financial statement purposes, and the converse if desired."

The intricacies in the tax code, as well as a frustrating lack of specific guidance, can also confuse the issues for many companies. "We've found that many clients know how to manage their P&L and balance sheet, but are not quite as adept at managing their tax strategies," observes Gamber. "Maximizing the yield from a sale-leaseback involves considering the effect of local, state and federal tax regulations. Some middle-market companies simply don't have the resources to undertake such analysis."

McAuliffe points out that an Illinois-based manufacturing company faced this issue when it decided to use a sale-leaseback to raise capital for acquisitions. As the GE Commercial Equipment Financing team researched the issues, it became apparent that there was an unfortunate twist—the transaction would be subject to a combined local and state sales tax of 8.75%, or about \$140,000.

"The thorny problem could have been a deal-killer; but we saw it as a simple hurdle to be overcome," recalls McAuliffe. "Our team researched local and state tax laws in a variety of venues in which the customer was domiciled for tax purposes and discovered that it would be advantageous to structure a transaction in Texas, which does not impose tax on the sale of manufacturing assets."

Points to Ponder

A sale-leaseback can offer the creation of significant sources of funds that can be used for varied purposes including the buy-back of capital stock, buying out a partner, paying off a specific lender, improving liquidity/working capital ratios or upgrading assets. But even the basic groundwork for a sale-leaseback requires far more detailed analysis than simply financing an asset subject to a purchase order. Issues that a corporation should, or may have to, consider when converting existing assets into cash capital include:

- ?? Consideration of current book value and adjusted capitalized cost, net of depreciation taken, for tax purposes

- ?? The impact of Net Operating Losses and Alternative Minimum Tax position
- ?? State Sale/Use Taxes and Exemptions by locale
- ?? Selection of the optimum package of assets that will yield the best economic results
- ?? The current fair market value of the asset(s)
- ?? The gain or loss for both book and tax purposes and any consequences
- ?? The planned use of funds generated by the transaction
- ?? The intended useful life of the assets and the economic impact of the replacement cycle
- ?? The desired cash flow timing of any sale-leaseback
- ?? The impact on existing bank debt and related covenants

Additional factors should also be considered. For example, notes McAuliffe, since a lessee may have no residual ownership rights to the sale-leaseback assets, the company may be tempted to use assets that are not expected to be of use beyond the life of the lease. However, that condition may also mean that these assets would hold a low value for the lessor, making it difficult to provide a good economic package to the lessee.

McAuliffe also raises the issue of non-tax oriented operating leases, which are generally structured as operating leases for financial accounting purposes, but are considered financing arrangements for tax purposes. "This type of lease is generally available as an alternative to true leases though it is much more difficult to employ it for a sale-leaseback," he says. "Such a transaction must be carefully analyzed to determine whether or not it satisfies FAS 13, thereby avoiding classification as a capital lease."

Another trap is installed equipment that may be classified as integral equipment, losing some of the book accounting benefits, such as off-balance sheet treatment, that a sale-leaseback might otherwise yield.

"The tax law governing leases is based on a number of rules; each transaction needs to be reviewed in light of these rules," warns McAuliffe. "Before entering into a sale-leaseback, management should consult with financial and tax advisors."

That's especially important in cross-border transactions, since the treatment of sale-leasebacks may vary from one country to another. While Wharton's Kostin notes that globalization could invite more consistent financial statement treatment on an international basis, standardization may be slow to arrive. He does not expect imminent changes in income tax and financial statement climates in the United States since the IRS recently promulgated advance ruling guidelines for leases that basically confirmed its leasing guidelines, which are nearly 50 years old.

In contrast, the basic financial statement guidelines on leases have been around for more than 20 years.

Despite the challenges that a sale-leaseback may present, “The leasing industry is sizable and growing,” observes Kostin. “Leasing transactions enable parties to arrange deals to include tax and accounting results as part of the yield but also to facilitate financing for growing companies without consistent profit records or that would otherwise be unable to access capital markets at acceptable cost. The current business environment has a plethora of such companies.”

