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SYNTHETIC LEASES Real Savings

By Jerrold J. Stern

A recent IRS pronouncement demonstrates one way to obtain tax advantages through the benefits of "synthetic leases." If structured properly, these leases allow the lessee to claim deductions for depreciation and other ownership costs of the property, such as insurance, taxes and maintenance, while keeping the debt associated with the property off the balance sheet. This is referred to as "off-balance-sheet financing."

Off-balance-sheet financing means the lessee is treated merely as a renter, and **not** as the owner of the property for financial accounting purposes. The asset and the long-term debt obligation represented by the lease are not included on the balance sheet. Rental payments are treated as period expenses. Classifying the transaction in this manner is beneficial for the lessee because the lease obligation does not affect the debt-equity ratio of the lessee, and, therefore, does not reduce the borrowing capacity of the lessee.

For example, the balance sheet of Glosser Bros., Inc., a retail store chain, shows $4 million of long-term debt and $32 million of equity — a debt-equity ratio of 1/8. If the company's long-term leases are included on the balance sheet at their capitalized value, total long-term debt increases by $70 million, raising the debt-equity ratio to much more than 2/1 ($74 million/$32 million).

According to the IRS, major users of commercial real estate who have substantial and highly specialized build-out costs and who are seeking medium-term, revolving-credit financing and an opportunity to maximize the value of their companies' stock are likely to benefit from off-balance-sheet financing.

IRS Scenario

In IRS Field Service Advice (FSA) 199920003, the taxpayer (T) is a retail store operation. T employs the help of a special-purpose entity (SPE) and various financial institutions in structuring synthetic leases. The SPE is a nominally capitalized, special-purpose corporation created solely for entering into synthetic leases. The SPE is unaffiliated with T, and T has no ownership interest in the SPE.

For a typical acquisition, T locates a property to be used as a retail store, distribution warehouse or production facility and negotiates a sales agreement. T arranges for the SPE to purchase and hold title to the property. A financial institution provides financing to the SPE based on T's creditworthiness. T guarantees all financing payments to the financial institutions. However, T does not guarantee any residual value in the properties.

Financial Accounting Operating Leases

For financial accounting purposes, T meets the four criteria necessary to classify the leases as "operating leases," which are associated with ordinary rental payments, rather than "financing leases," in which each payment made by T represents principal and interest. The criteria are:

- T does not acquire title to the properties.
- There is no bargain purchase option.
- The lease term is less than 75 percent of the property's estimated economic life.
- The present value of the rent is less than 90 percent of the property's fair market value.

The Tax Owner

Thus, while T is not the owner of the property for financial accounting purposes, the IRS allows T to be the owner for tax purposes. Using a "facts and circumstances" approach, the IRS identifies several factors critical to its determination. The SPE's ability to finance each property is totally dependent on T. The rental payments are computed to cover the SPE's borrowing costs, rather than to reflect fair rental value. In fact, rent payments fluctuate based on changing interest rates.

T guarantees the debt and pays all operating costs, including maintenance, repairs, insurance and property taxes. The SPE and T agree that T is entitled to all depreciation deductions. The SPE cannot transfer or sell the leases unless T agrees. The IRS concludes that T and the SPE have a genuine multiparty transaction with economic substance that is compelled or encouraged by business realities and not shaped solely for tax avoidance reasons.

Tax planning for this type of transaction obviously is quite complicated. In fact, IRS labeled their synthetic lease ruling a "close and difficult call." Consultation with an accountant, attorney or commercial real estate professional is recommended.

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