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Leveraging Sale and Lease Back Transactions in Today's Economic Environment

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Sale and leaseback (sale-leaseback) transactions have long been very popular as they represent benefits to both the seller-tenant and buyer-landlord. However, in today's post-pandemic real estate market, where many properties remain in high demand and financing costs are rising, the popularity of sale-leaseback transactions is emerging as an attractive vehicle for owners and investors of real estate as a mechanism for tapping into a readily available source of capital. When compared to other types of commercial real estate and stock market investments, a properly structured sale-leaseback transaction can be a more attractive investment vehicle for both sellers and purchasers.

In its simplest form, a sale-leaseback transaction typically involves the sale of real estate, although it could apply to other types of assets, by an operating business that owns the real estate, either directly or through an affiliated entity, to a purchaser who then immediately leases the real estate back to the seller. The purchaser, who becomes the landlord, is often a real estate investment trust (REIT) or other third-party real estate investor equipped to own or finance income-producing real estate across a wide range of sectors.

These types of transactions offer several benefits for both parties. The primary benefit to the seller, who becomes the tenant, is the opportunity to free up cash from an otherwise illiquid asset without having to relocate its business. The seller can then redeploy the cash in its business for other purposes. For example, the seller can use the sale proceeds from the real estate, less any capital gains tax, to improve the seller's overall balance sheet by paying off debts and/or investing in the growth of the business. Comparatively, conventional mortgage financing normally funds only 70-80 percent of the real estate value. Given today's environment of rising interest rates, it is also advantageous for a business to pursue a sale-leaseback transaction to lock in a long-term rental rate while interest rates continue to rise. There are also favorable tax opportunities for the seller, including the possibility of deducting rent from the business' income. By making strategic business choices now, a business can better position itself to address the impacts of an economic downturn.

The primary benefit to the purchaser, who becomes the landlord, is the opportunity to acquire real estate from an established business with a contractual source of income from the lease, with low operational obligations and the possibility of taking depreciation deductions where the purchase involves improved land. The lease is typically a long-term "triple net lease," meaning the seller-tenant agrees to pay all real estate taxes, maintenance, and building insurance on the property in addition to other costs that are described in the lease. Additionally, the lease tends to have higher cap rates than other triple net leases. If structured properly, a sale-leaseback transaction is not considered a loan and therefore state usury laws do not apply. Consequently, a purchaser can earn a higher rate of return on the lease than if it had made a conventional mortgage loan to the seller-tenant.

While beneficial, sale-leaseback transactions also have some risks for both sellers and purchasers. For example, the seller under a sale-leaseback transaction no longer maintains an ownership interest in the real estate and thus, no longer maintains control of the real estate. This subjects the seller to terms of the lease, which often reflect the purchaser’s goals with the real estate, rather than what may be best for the seller operating its business on the real estate. For instance, the lease may prohibit the seller-tenant from making beneficial capital improvements or alterations under the lease. Further, if the operating business is not performing well, the choices for relocation or dissolution are limited by the lease terms, which may restrict assignments of the lease and result in severe penalties in the event of a default. Additionally, at the end of the lease, the seller-tenant is forced to either renegotiate a lease extension, repurchase the real estate, or relocate. The seller may also incur immediate negative tax consequences by having to recognize gain on the initial sale of the real estate.

A sale-leaseback transaction also has drawbacks for the purchaser. The purchaser enters into the transaction contingent upon the execution of a long-term lease with the seller and, therefore, must rely on the seller’s performance under the lease. While the purchaser can negotiate favorable lease terms, if the seller fails or defaults under the lease, the purchaser may not achieve its goals with the transaction. In some cases, a purchaser may need to make special considerations under the lease that it would not typically make to other tenants due to the fact that the proposed tenant owns and controls the real estate and can prevent the seller from purchasing the real estate until such considerations are included in the lease. This can make the lease more expensive to the purchaser if the seller requires that tenant improvements be made to the real estate or financed by the purchaser. Additionally, the existing or prospective improvements on the real estate may not be useful to future tenants, which may increase the cost of owning the real estate upon termination of the lease.

Finally, while a sale-leaseback transaction can be beneficial to both parties involved, such a transaction needs to be properly structured in order to minimize risks, including the risk that the IRS may attempt to disallow deductions or such things as depreciation, rental payments and interest by the parties on the grounds that the transaction constitutes a loan or exchange for like-kind property. That said, all parties need to understand the business and tax advantages, disadvantages and risks in this type of structure before moving forward. This article has only provided a high-level of such business and tax advantages and disadvantages.

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