The Pros and Cons of a Sale Leaseback Transaction

Have you ever wondered how you can obtain additional cash to fund your business's growth and expansion? One option to consider is a sale leaseback transaction of the business's real estate. This type of transaction can be a source of cash under the right circumstances.

The final result of a sale leaseback transaction is the selling of your real estate in exchange for cash, while also retaining the right to use the facility under a long-term lease agreement with monthly, quarterly or annual rental payments.

A few benefits of this type of transaction include:

- A source of cash that is equal to 100% of the value of the facility, versus 75% or 80% of the facility's value that can be generated with traditional lending sources. However, the additional sourced cash may be mitigated with the transaction costs and potential income taxes on the taxable gain from the sale. The tax and the transaction costs can be significant so an analysis of the taxes and fees should be done to determine the actual cash benefit.
- Maximizing your access to cash when lending sources are not available or are expensive. In situations where traditional lending sources are unable or unwilling to lend you additional funds on the value of the building or the costs, such as transaction fees and/or interest rates are excessive the cash flow from the sale of the real estate may be the only option.
- Upcoming or potential sale of the operating business. In most transactions, companies are sold on a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization). Many times the buyer is not interested in owning the building or unwilling to pay full value for the facilities, but values a long-term location for business operations. In these cases, the sale of the building separate from the operating entity can maximize the total proceeds you receive for your business.

  If you are selling your corporation or S corporation business but want to retain the equity in your building, it may make sense to do the sale yourself to strip the equity from your business and thereby make it more attractive to prospective buyers. Meanwhile, you keep the real estate under a lease arrangement, which could be attractive to you over the long term. Then, just relax and cash the rent checks! Income tax rules can make related party rules complex. In bulk transactions, gains and losses often cannot be netted and gains are sometimes exposed to ordinary tax rates while losses are sometimes disallowed. Thoughtful planning is required in related party transactions.

  Tax planning in advance of a sale needs to address the amount of gain or loss, its character (tax rate), and timing. Each property is unique, so without paying attention to income tax planning, you will likely pay more in taxes than you need to. Income tax-focused appraisals may influence the character of the income. Installment sale rules can be used to control the timing of income recognition.

  A sale leaseback can be a lynchpin for expansion. Sell your existing building in a tax-deferred like kind exchange under Section 1031, and deploy the cash in an investment in new real estate elsewhere while leasing back the existing facility. Done properly, the transaction has no current income tax and allows the business to grow with ownership of the most strategically important real estate. This prevents the balance sheet from getting bloated with illiquid real estate and mortgage debt while still locking up the strategically important assets. You can even keep a repurchase option on the old building if you need it.

- Improved balance sheet leveraging. By selling the building, its debt will be paid off and the overall debt to equity ratios will improve. This will help the financial strength of the balance sheet and can assist in additional bank financing.
- Eliminate the risk of devaluing real estate markets. By selling your property, any future down-turns in property values will have no effect on the businesses balance sheet.

The disadvantages of these transactions include:

- Lost future value growth in the real estate. After a sale Leaseback transaction, you have locked in your return on the real estate – for better or worse. The property's value may significantly increase, which can be a lost investment opportunity.
- You may not be able to modify the facility to adapt to changing business needs. Any remodeling restrictions and ability to renew the lease need to be properly addressed when drafting the lease agreement.
- Taxes, taxes, and taxes. If the property is fully depreciated, your gain on the sale will likely be significant with both capital and ordinary tax rates.
- Transaction costs may be substantial. Deed taxes, early termination of old financing, new financing origination, negotiation costs, etc., need to be understood. Further, the sale may have implications for future real estate tax obligations on the property, which is a cost that might be borne by the lessee under the lease.
- If you've recently elected S corporation status, a sale leaseback can be a built-in gain tax item.

There are also alternatives to these transactions, including:

- Contributing to a partnership and leaseback. In this situation, the business drops the real estate into a new partnership (or LLC) while a partner contributes cash. The cash may fund a building addition or a rehab. Usually a partnership style transaction can be done without current income tax cost. Your partner might also be contributing something other than cash, like other real estate, business commitments, etc.
- Consider subdividing. If your real estate tract can be split (or if it is already split), consider outright sale of excess facilities. Reduce your footprint if the shoe is too big!

If you are looking for a source of cash and are considering a sale leaseback transaction, review the benefits and disadvantages to determine if it will result in better cash flow, risk management, and overall business success. Also examine the other options available, and avoid common pitfalls by asking your real estate, financial, and legal advisors for their input. Planning will be the key to a positive outcome.

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