Sale/Leaseback Transactions and Section 1031 Tax Code Sales of Real Estate

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Introduction

- Overview of sale/leaseback and §1031 markets
  - Impact of the economy
  - Effects of accounting changes for sale/leasebacks

- General Trends

Sale/Leaseback Overview

- Form of “credit tenant lease”: Lease to creditworthy tenant
- Owner-occupied property sold to third party and leased back
- Operating lease treatment for Lessee for financial accounting purposes

Transaction Parties

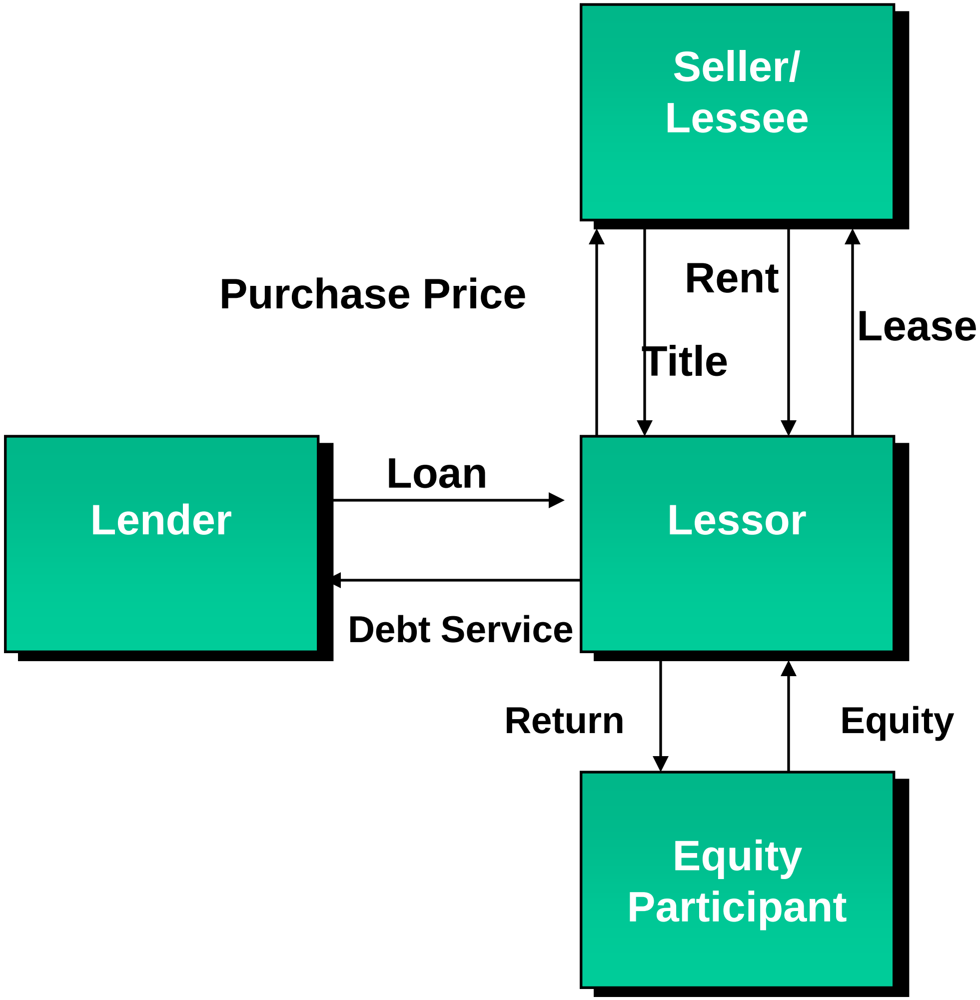
Seller/Lessee: Typically, creditworthy tenant

Lessor: Single investor or multiple investors; may be institution or SPE

Equity Participant: Tax-motivated investor (eg., 1031 investors or others) or real estate investor

Lender: Insurance companies investing in CTL or other financial institutions

Sale-Leaseback Overview



Accounting Rules

- Accounting Treatment: Debt and asset off-balance sheet under current rules
- Basic Rules:
  - No automatic transfer to Lessee at end of term
  - No bargain purchase option for Lessee
  - Lease term less than 75% of useful life
  - PV of rent less than 90% of FMV of property
- For real estate leases – no "continuing involvement":
  - No option or obligation for Lessee to purchase property
  - No guarantee by Lessee of Lessor's investment or return on investment
  - No sharing of appreciation with Lessor

Tax Treatment

- Lessor
  - Tax owner
  - Entitled to depreciation deductions
- Lessee
  - Deduction for rental expense
- Early buy-outs limited
  - Not permitted under accounting rules if sale-leaseback
  - If not a sale-leaseback (i.e., if lessee was not seller), EBOs limited by tax guidelines
- Tax indemnities in some deals

Lessee Perspective

- Raise equity
- Real estate not part of company's core business
- Accounting treatment (subject to change)
- Operational control
- 100% financing
- Predictable rents
- Long term:
  - Typically 20 years, with long term renewals

Other Considerations

- Is it really expensive debt?
- Loss of flexibility
- Expansion and alterations can be problematic
- Financing of expansion may be difficult
- Proposed change in accounting rules

Agreement of Sale

- Reps and warranties
- Pro-rations
- Liability of Seller/Lessee and Buyer/Lessor compared to typical PSA
- Closing deliveries
- Survival
- Conditioned on entering into lease at closing
- Often signed at closing

Lease

- Term
  - Minimum term – usually at least 20 years plus renewals
  - Consider transfer taxes
- Rent
  - Fixed rent
  - Usually based on purchase price
  - Limited fixed rent renewals
  - RVI if rent does not fully amortize debt

Lease (cont'd)

- "Bond-type" lease
  - Few lessor obligations – Lessee to consider covenant of quiet enjoyment
  - No offsets against rent
- Limited termination rights
  - Triple Net vs Absolute Net
  - Condemnation
- Typically few (if any) financial covenants

Lease (cont'd)

- Operational control by Lessee with limitations
  - Assignment and subletting/non-disturbance
  - Change in use
  - Repairs and improvements
  - Modifications, releases, dedications, etc.
  - Excess land
- Financing issues
  - Leasehold mortgage financing by Lessee?
  - Use of casualty insurance proceeds

Lease (cont'd)

- No purchase options by Lessee in sale/leaseback
- Rejectable offer for casualty/condemnation
- Right of first refusal/right of first offer
- Economic abandonment
- Substitution of property

Other Documents

- SNDA
- TIA
- Loan Documents
- RVI

Final Notes

- Securitization of loan
- NAIC guidelines
- Due diligence
  - Title
  - Survey
  - Property condition
  - Appraisal
- Recharacterization risk
- Accounting rule changes
- A word on synthetic leases

Section 1031 Like-Kind Exchanges

A Section 1031 allows a taxpayer to exchange property for other property without the recognition of a gain for tax purposes.

Carlton, June v. U.S., 385 F. 2d 238 (5th Cir.1967).

Four Basic Requirements for a §1031 Exchange

1) There must be an exchange.

2) The properties must be used in a trade or business (or for investment).

3) The properties must be of like-kind.

4) The properties must not be disqualified properties.

Exchange

- Must be a reciprocal transfer of property.
- Cannot be simply a sale and a purchase.
- You can receive boot; however, the boot may be taxable.

Must Be Used in a Trade or Business (or for Investment).

- In other words, it cannot be property held for personal purposes.

- This is not an issue for any property held by our businesses.

Must be of Like Kind

- "Like Kind" relate to the nature and character of the property and not its grade or quality. Treas. Reg. 1.1031(a)-1(b).

- Generally, all real estate is "like kind."

- Real property located in the U.S. is not "like kind" to real property located outside the U.S. 1031(h)(1)

- Leasehold of a fee with 30 years or more is deemed "like kind" to other real property. 1.1031(a)-1(c)(2).

Disqualified Property

The following are disqualified:

1) Stock in trade or other property held for sale
2) Stocks, bonds and notes
3) Other securities or evidence of indebtedness
4) Interests in a partnership
5) Certificates of Trust or beneficial interest
6) Choses in action

Delayed Exchanges

- Section 1031 allows a taxpayer the possibility to structure a "delayed" exchange.
- Two Timing Requirements:

1) The taxpayer has 45 days from the date of transfer of the relinquished property to identify replacement properties.
2) The taxpayer must acquire the replacement property within 180 days of the date on which the taxpayer transferred the relinquished property.

Calculation of Gain and Tax Basis – Example 1

- Relinquished property is worth \$2,500,000 with an adjusted basis of \$1,200,000.

- Replacement property is worth \$2,000,000. Taxpayer receives \$500,000 cash in addition to the Replacement Property.

- The tax results are as follows:
  - Amount Realized (Replacement Property plus Boot) \$2,500,000
  - Adjust Basis of Relinquished Property \$1,200,000
  - Gain Realized \$1,300,000

- The taxpayer would recognize gain of \$500,000 (amount of the boot)
- The taxpayer's adjusted basis in the replacement property would be \$1,200,000.

Calculation of Gain and Tax Basis – Example 2

- Relinquished property is worth $2,500,000 with an adjusted basis of $2,200,000.

- Replacement property is worth $2,000,000. Taxpayer receives $500,000 cash in addition to the Replacement Property.

• Amount Realized (Replacement Property plus Boot)	$2,500,000
• Adjust Basis of Relinquished Property	<u>$2,200,000</u>
• Gain Realized	$ 300,000

- The taxpayer would recognize gain of only $300,000 (amount of realized gain).
- <u>However</u>, taxpayer's adjusted basis in the replacement property would be $2,000,000

Reverse Exchanges

- It is possible for a taxpayer to acquire replacement property prior to transfer of the relinquished property.

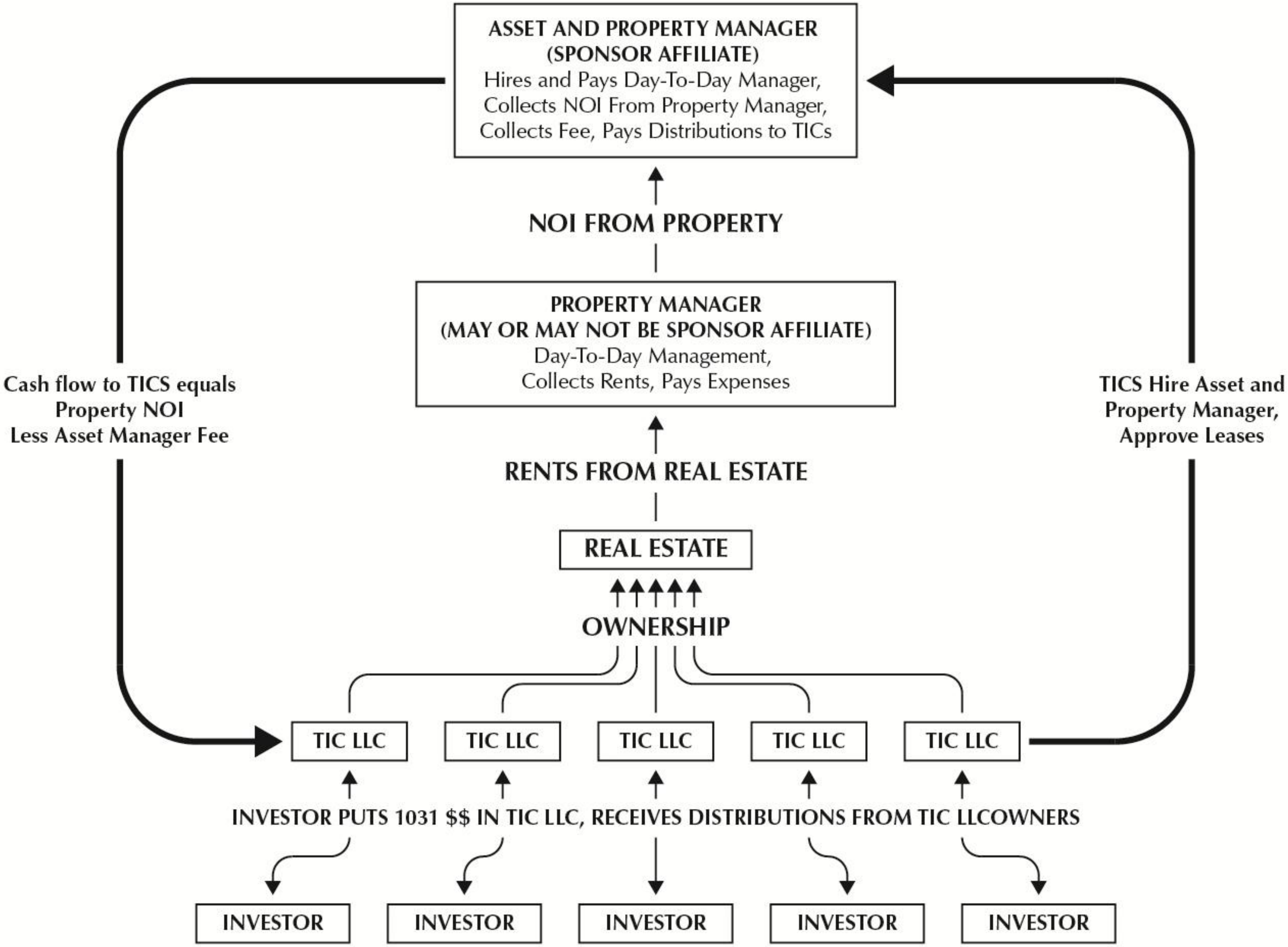
- Rev. Proc. 2000-37

Section 1031 Issues with Sale/Leasebacks

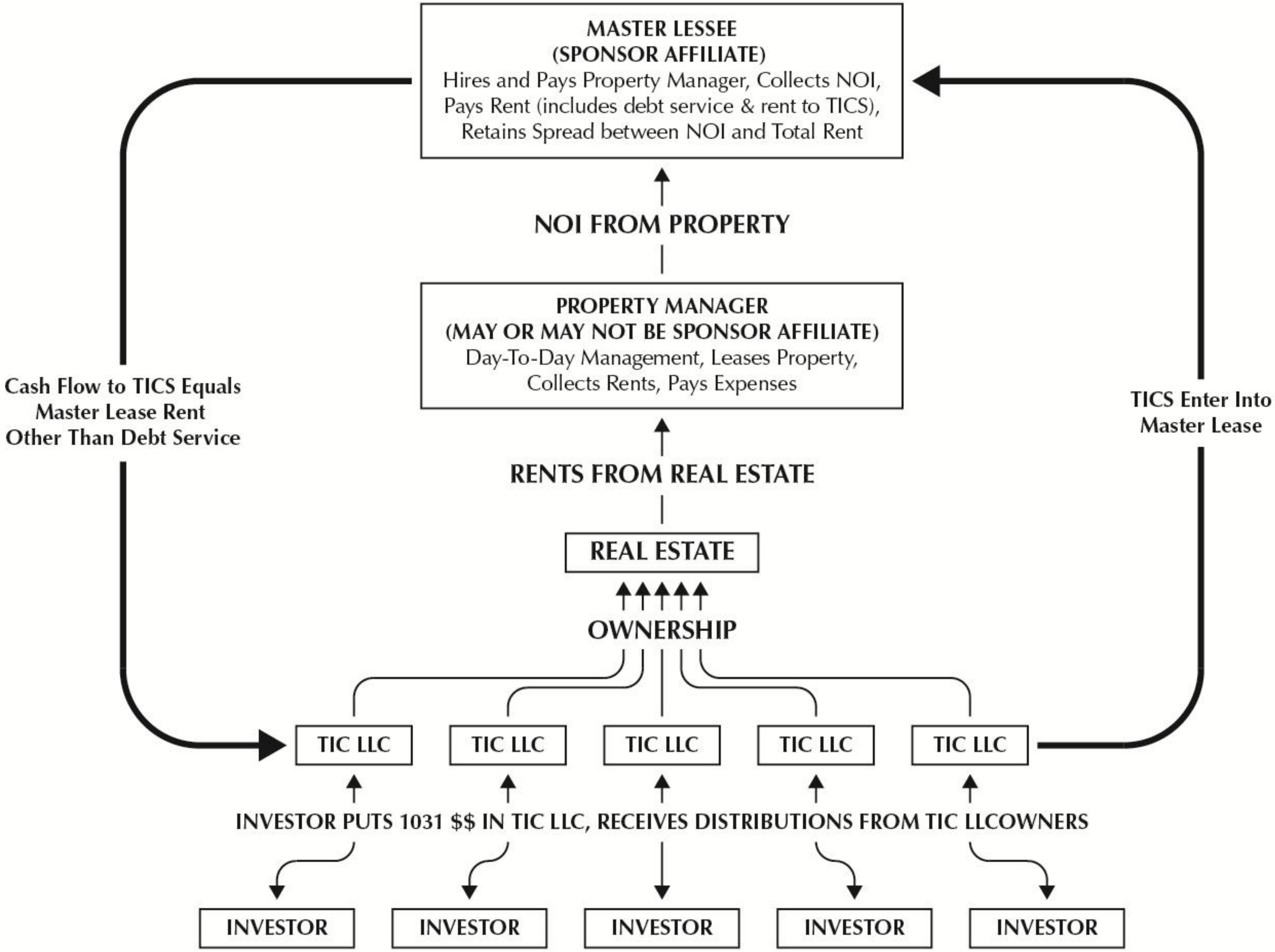
- Term of Lease

- *Crowley* case

TIC WITH SPONSOR ASSET/PROPERTY MANAGER



TIC WITH MASTER LEASE TO SPONSOR



Delaware Statutory Trusts

- A legal entity separate from its owners under Delaware law
- Assets are owned by the trust
- An independent trustee oversees the trust
- Day-to-day operations are overseen by a manager
- Owners receive trust certificates, instead of direct ownership in the assets or shares (as in a corporation)
- Fixed investment trust with no power to vary the investment under IRS regulations
- Qualifies for Section 1031 Exchange

TIC vs DST -- Similarities

- Investors can purchase their interests using 1031 exchange funds
- Both are securities for federal securities law purposes
- Sponsor master leases the property at closing
- Investors can do a 1031 exchange upon disposition
- Sponsor affiliate can have a purchase option at fair market value

TIC vs. DST -- Differences

TIC

- Multiple owners of real estate
- Unanimous TIC consent for certain actions
- Each TIC is a borrower and
- Each TIC must be approved by the lender
- TICs sign a "bad boy" guaranty
- Additional capital contributions possible
- A TIC is real estate for state law and tax purposes

DST

- Single owner of real estate
- Investors do not have a vote
- Single borrower
- The lender approves only the DST as a borrower
- Sponsor affiliate signs a "bad boy" guaranty
- No additional capital contributions possible
- A DST not real estate for state law or tax purposes (though it qualifies for 1031 exchange as a fixed investment trust)

Questions or Comments?