CPE Article

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SALE-LEASEBACK TRANSACTIONS, NOW AND THEN

Curriculum: Accounting and Auditing

Level: Intermediate

Designed For: Business and Industry, Public Practice and Tax Practitioners.

Objectives: To discuss the impact of the recent revenue and lease exposure drafts on sale-leaseback transactions.

Key Topics: Lease accounting and revenue recognition.

Prerequisites: None

Advanced Preparation: None

Companies use sale-leaseback transactions to unlock the equity that they have in their assets, such as machinery and equipment, and convert it to cash. They accomplish this by conveying the title of their assets at fair value to a third party (usually a financial institution) in exchange for lump-sum cash payments. The third party then leases back the assets to the company. However, there are proposed changes to the current accounting for sale-leaseback transactions, which may limit some of its financial advantages.

In August 2010, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly released an exposure draft (ED), *Leases*, and proposed an accounting model that would significantly change lease accounting. One of the objectives of this ED is to ensure assets and liabilities arising from leasing transactions are reflected on the company's statement of financial position. The subsequent comment period produced significant concern about the complexity of the guidance. As such, the two Boards announced in July of 2011 they would re-expose the proposed leasing standard in 2012 and issue the final standard by late 2013.

The Boards also jointly issued another ED in June 2010, *Revenue from Contracts with Customers*, to supersede virtually all existing revenue guidance under U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The comment period for this ED ended in October 2010. The Boards decided to re-expose their revenue proposal in November 2011 subsequent to deliberations. The comment period for the revised ED was 120 days and ended on March 13, 2012. The Boards plan to continue their re-deliberations and outreach on the revised revenue recognition ED and issue the final standard by mid-2013.

The proposed lease and revenue guidance have important business implications for sale-leaseback transactions. The planned recognition of significantly more assets and liabilities along with related amortization and interest expense in financial statements would impact the contract negotiations, financial ratios, and business systems for public and private entities. The objective of this article is to analyze the impact of the lease and revenue EDs on sale-leaseback transactions.

SALE-LEASEBACK TRANSACTIONS

A sale-leaseback transaction involves the sale of an asset and lease-back of the same asset by a seller/lessee. In a typical sale-leaseback transaction, the seller sells an asset to the purchaser, yet retains the right for a long-term continued use of the asset through a leasing arrangement. Essentially, the transaction is arranged so that the purchaser/lessor relinquishes control over the asset through a leasing arrangement, which gives the seller/lessee the same control and responsibility over the asset. The seller/lessee retains a future interest in the asset (generally through options to purchase), so that after a certain time period, the seller/lessee may repurchase the asset.

Under such an arrangement, the seller/lessee secures capital, while retaining use of the asset, and the purchaser/lessor, as owner, may receive tax benefits such as depreciation deductions and interest deductions arising from loan indebtedness. The seller/lessee may take deductions on rental payments. The benefits of these deductions generally outweigh the loss of tax benefits related to depreciation deductions that the seller/lessee foregoes by relinquishing ownership of property.

The rental payments made by the seller/lessee over the course of the lease term typically match the purchaser/lessor's principal plus interest on the loan for the property. The purchaser/lessor typically retains a reversionary interest, subject to future options to purchase, or extensive lease renewal options by the seller/lessee.

Entities, such as airline and real estate companies, have traditionally entered into sale-leaseback transactions for a variety of reasons and purposes, including the following:

- alternative financing,
- tax considerations,
- strengthening the balance sheet.

Alternative Financing

Sale-leaseback transactions can provide a source of financing and liquidity. For example, Southwest Airlines raised $381 million from sale-leaseback transactions during 2009, greatly contributing to its 2009 ending cash balance of $1.1 billion. (http://sec.gov/Archives/edgar/data/92380/000119312512049647/d293991d10k.htm)

Sale-leaseback transactions can provide more funds than a comparable loan using the same asset as collateral since it allows the seller/lessee to raise cash for the full value of the asset, whereas the collateralized loan allows the entity to raise funds typically less than 100 percent of the asset's value.

Tax Considerations

Sale-leaseback transactions have several tax advantages for the lessees compared to collateralized loans discussed in the previous paragraph. For example, lease payments are fully deductible in sale-leaseback transactions, whereas only the interest portion of their collateralized loan payments may be deducted.

Sale-leaseback transactions can create capital gains and losses for the seller/lessee, which potentially diminish the impact of unexpected tax situations. For example, during the recent financial crisis, many

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companies accumulated significant capital losses, potentially offsetting capital gains created by sale-leaseback transactions.

If seller/lessees cannot take full advantage of accelerated depreciation, they may structure a deal with a third-party leasing company to sell their assets and lease them back. Both seller/lessee and purchaser/lessor may benefit from such transaction. The purchaser/lessor can possibly pass the benefits that it receives from accelerated and bonus depreciation, and Section 179 expensing to the seller/lessee through lower lease payments, while seller/lessee may benefit by possibly receiving capital gains and securing alternative financing.

Structuring a genuine sale-leaseback transaction amenable for tax purposes requires careful planning. Historically, the Internal Revenue Service (IRS) has considered sale-leaseback transactions as "sham" transactions, lacking any economical substance and thus void for tax purposes.

Some companies have used crafty financial maneuvering to make risk for both parties nonexistent. For example, the purchaser/lessor would take out a loan from a third party and use the loan proceeds to pay for the purchase of the assets. The seller/lessee, on the other hand, uses those proceeds to make rent payments for the use of its sold assets. The purchaser/lessor uses those rent payments to pay back its loan, rendering the financial arrangement almost entirely circular and off-setting. The IRS may question such sale-leaseback transactions on the grounds that the true ownership does not reside with purchaser/lessor, particularly where the seller/lessee is obligated to pay for improvements and maintenance, property taxes, and insurance (only a true owner normally undertakes such responsibilities).

Strengthening the Balance Sheet

A few years ago, the Securities and Exchange Commission (SEC) estimated the undiscounted amount of off-balance-sheet lease obligations at approximately $1.25 trillion (http://www.sec.gov/news/studies/soxoffbalancerpt.pdf). One of the advantages for the seller/lessee in a sale-leaseback transaction under the current guidance is the possibility that the lease may be recognized as an operating lease with off-balance-sheet liabilities. Solvency metrics such as the current ratio, as well as other metrics such as debt to equity, return on equity, and interest coverage, are all affected positively with such an accounting treatment.

For example, Southwest Airlines leases a good portion of its assets, some of which are the results of sale-leaseback transactions. The majority of Southwest's terminal operations space, as well as many of its aircrafts, were classified as operating leases as of Dec. 31, 2011. Total rental expenses for operating leases in 2011 and 2010 were $847 million and $631 million, respectively. Future operating rent expense commitments were $5,583 million at the end of fiscal year 2011, while current liabilities and long-term debt net of current portion at the end of the fiscal year 2011 were $4,533 million and $3,107 million, respectively. (http://www.sec.gov/Archives/edgar/data/92380/000119312512049647/d293991d10k.htm)

THE CURRENT U.S. GAAP GUIDANCE AND SALE-LEASEBACK TRANSACTIONS

Under the current guidance in a lease arrangement, the lessee can potentially account for leases either as operating or capital leases depending on certain circumstances. In an operating lease, the lessee reflects the lease rentals in the statement of operations on a straight-line basis. In a capital lease, on the other hand, the lessee measures the liability based on the estimated lease term at the present value of the estimated future lease payments, discounted using the lessee's incremental borrowing rate or, if it cannot be readily determined, the rate the lessor charges the lessee. This provision is available to a seller/lessee in a sale-leaseback arrangement.

The current guidance treats a sale-leaseback arrangement as a financing transaction in which any profit or loss on the sale is deferred and amortized by the seller/lessee. The seller/lessee amortizes the deferred profits and losses over the lease term or the leased items' economic life for capital leases; for operating leases, the seller/lesser amortizes deferred profits and losses in proportion to the rental payments over the period of asset use.

An exception to deferring the profit and loss occurs when the seller/lessee relinquishes the right to substantially all of the remaining use of the property sold. In that case, the sale and the leaseback shall be accounted for as separate transactions, and the lessee recognizes gains and losses immediately.

The sale-leaseback rules do not impact the purchaser/lessor's accounting. A purchaser/lessor involved in a sale-leaseback transaction usually accounts for the transaction as the acquisition of an asset and either a corresponding financing or operating lease out.

THE PROPOSED GUIDANCE AND SALE-LEASEBACK TRANSACTIONS

Under the current guidance, sale-leaseback transactions can result in off-balance-sheet liabilities for the seller-lessee when a sale is recognized and the lease is classified as an operating lease. The lease ED, on the other hand, proposes that sale-leaseback transactions would no longer be off-balance sheet since lessees would be required to recognize all leases in their balance sheets (Rashty and O'Shaughnessy, "The Ever-Changing Lease Exposure Draft," *Today's CPA*, November/December 2011). Sale-leaseback transactions may also be affected by the *Revenue from Contracts with Customers* ED re-exposed in November 2011.

TABLE 1.

1 Call options (IG40)	Seller/lessee has an unconditional right to repurchase the leased asset	If the repurchase price is equal or higher than original selling price, the transaction is a financing arrangement. If the repurchase price is less than original selling price, the transaction is within the scope of *Lease* guidance.
2 Forward rights (IG40)	Seller/lessee has an unconditional obligation to repurchase the leased asset	If the repurchase price is equal or higher than original selling price, the transaction is a financing arrangement. If the repurchase price is less than original selling price, the transaction is within the scope of *Lease* guidance.
3 Put options – the repurchase price is equal or higher than original selling price	Purchaser/lessor has an unconditional right to require the seller/lessee to repurchase the asset	If the repurchase price is equal or greater than expected market value of the asset, the transaction is a financing arrangement (IG46). If the purchaser/lessor does not have significant economic incentives to exercise the put option, then transaction is a sale with a right of return and within the scope of *Revenue Recognition* guidance (IG45).
4 Put options – the repurchase price is less than original selling price	Purchaser/lessor has an unconditional right to require the seller/lessee to repurchase the asset	If the purchaser/lessor has a significant economic incentive to exercise the put option, the transaction is within the scope of *Lease* guidance (IG43). If the purchaser/lessor does not have significant economic incentive to exercise the put option, the transaction is a sale with a right of return and is within the scope of *Revenue Recognition* guidance (IG45).

The Boards have tentatively decided that a seller/lessee would now apply the guidance in the revenue recognition standard to determine whether to recognize a sale of the underlying asset. If the revenue recognition standard's requirements for sale accounting are met, the transaction would be accounted for as a sale and leaseback of the underlying asset; otherwise, the transaction would be accounted for as a financing of the underlying asset, requiring the asset to remain on the seller/lessee's balance sheet.

Generally, a sale-leaseback transaction that does not qualify as a sale would be accounted for as a financing of the underlying asset. A sale-leaseback transaction that is accounted for as a sale and leaseback would result in de-recognition of the underlying asset by the seller/lessee and recognition of a gain or loss for the difference between the consideration received from the purchaser/lessor and the carrying value of the underlying asset.

The amount of the gain or loss would be adjusted to reflect current market rates for the lease of the underlying asset if the transaction price is not at market price. If the transaction qualifies as a sale, a gain or loss would be recognized immediately. The Boards have also proposed that if the sale or leaseback is not established at fair value, the asset, liability and gain or loss would be adjusted to reflect current market rentals. The seller/lessee would recognize a right-of-use asset and a lease liability for the leaseback of the underlying asset in transactions that qualify as sales.

The proposed guidance treats short-term leases (leases of 12 months or less) similar to operating leases under the existing guidance. Table 1 summarizes the impact of the repurchase provision in sale-leaseback transactions under the *Revenue Recognition* ED paragraphs IG38-IG48.

LATEST DEVELOPMENTS

In June 2012, the Boards announced that they support a principle for classifying leases based on whether the lessee acquires and consumes more than an insignificant portion of the underlying asset over the lease term. Based on that decision, leases would be classified as either leases of property (i.e., land, building or part of a building), recognized as straight-line leases, or leases of assets other than property (e.g., equipment), recognized as accelerated leases.

Lessors would apply operating lease accounting to straight-line leases and the Receivable & Residual (R&R) approach to accelerated leases (Rashty and O'Shaughnessy, "The Ever-Changing Lease Exposure Draft, Part II – Lessor Accounting," *Today's CPA*, May/June 2012). Lessors following operating lease accounting would neither recognize a lease receivable nor derecognize a portion of the underlying asset even though the lessee would recognize a liability for future lease payments and a corresponding right-of-use asset.

ILLUSTRATION

Entity S (the seller/lessee) sells equipment with a fair market value and book value of $37,000 to Entity P (the purchaser/lessor). Assume that fair market value is equal to book value to simplify the illustration.

Entity P enters into a three-year lease agreement with Entity S.

The carrying value (CV) of the equipment is $37,000, which is equal to its fair market value (FV) at the commencement of the lease, and the equipment is estimated to have a residual value of $5,000 at the end of the three-year lease. The total lease receivable (LR) at the commencement of the lease was $32,832. Entity S has an unconditional right to repurchase the equipment (a call option) at $5,000 and exercises this option at the end of the lease term. Assume that residual value is equal to fair market value to simplify the illustration.

Entity P charges Entity S a monthly lease payment of $1,000 in arrears, which is equal to 6.08 percent return (the implicit rate in the lease agreement). The lease receivable for $32,832 is equal to the

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EXHIBIT I

Receivable and Residual Approach – Sale/Leaseback – Purchaser/Lessor's Perspective

Journal Entries:

Year	Cash	Lease Receivable	Residual Asset	Underlying Asset	Lease Revenue	Interest Income
0	($37,000) (a)			$37,000 (a)		
0	$ -	$32,832 (d)	$4,168 (f)	($37,000) (h)	$ -	
1	$12,000 (b)	($10,287) (e)	$261 (g)		($1,713) (i)	($261) (g)
2	$12,000 (b)	($10,931) (e)	$277 (g)		($1,069) (i)	($277) (g)
3	$12,000 (b)	($11,614) (e)	$294 (g)		($386) (i)	($294) (g)
3	$5,000 (c)		($5,000) (c)			

a. Purchase of equipment from lessee for $37,000.
b. Annualized monthly lease payments of $1,000.
c. Sale of equipment to lessee for $5,000 at the end of the lease due to lessee's exercise of call option.
d. Lease receivable is equal to the present value of an ordinary annuity of $1,000 discounted at 6.08 percent over 36 months.
e. Collection of lease receivable amortized using the effective method at 6.08 percent.
f. Residual asset represents the rights to the underlying asset retained by the lessor and is equal to CV – (CV X (LR/FV)) or $37,000 – ($37,000 X ($32,832/$37,000)) = $4,168.
g. The residual asset is accreted using 6.08 percent interest rate to arrive at $5,000 residual value at the end of the lease.
h. De-recognition of asset due to leaseback.
i. The lease revenue on the lease receivable, which is amortized using the effective method at 6.08 percent.

EXHIBIT II

Receivable and Residual Approach – Sale/Leaseback – Seller/Lessee's Perspective

Journal Entries:

Year	Cash	Right to Use Assets	Underlying Asset	Liabilities	Amortization Expense	Interest Expense
0	$37,000 (a)		($37,000) (a)			
0		$32,832 (d)		($32,832) (d)		
1	($12,000) (b)	($10,944) (e)		$10,287 (f)	$10,944 (e)	$1,713 (g)
2	($12,000) (b)	($10,944) (e)		$10,931 (f)	$10,944 (e)	$1,069 (g)
3	($12,000) (b)	($10,944) (e)		$11,614 (f)	$10,944 (e)	$386 (g)
3	($5,000) (c)		$5,000 (c)			

a. Sale of equipment from lessee for $37,000.
b. Annualized monthly lease payments of $1,000.
c. Purchase of equipment from lessor for $5,000 at the end of the lease due to lessee's exercise of call option.
d. Right to use assets and liabilities are equal to the present value of an ordinary annuity of $1,000 discounted at 6.08 percent over 36 months.
e. Amortization of the right to use assets.
f. Lease payments less applicable interest.
g. Applicable interest at 6.08 percent.

present value of the lease payments discounted at 6.08 percent. The Exhibits I and II reflect the journal entries in purchaser/lessor and seller/lessee books.

POSSIBLE DETERRENT

The new guidance would undoubtedly impact the structure and most likely the number of future sale-leaseback transactions. The proposed guidance that sale-leaseback transactions no longer be considered off-balance-sheet items may serve as a deterrent to companies' decisions to engage in such transactions. Nevertheless, sale-leaseback transactions will continue to appeal to many companies, in one form or the other, as an alternative source of financing with potential tax advantages. ■

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CPE Quiz

Sale-Leaseback Transactions, Now and Then

BY JOSEF RASHTY AND JOHN O'SHAUGHNESSY

Today's CPA offers the self-study exam below for readers to earn one hour of continuing professional education credit. The questions are based on technical information from the preceding article. Mail the completed test by **April 30, 2013**, to TSCPA for grading.

If you score 70 or better, you will receive a certificate verifying you have earned one hour of CPE credit – granted as of the date the test arrived in the TSCPA office – in accordance with the rules of the Texas State Board of Public Accountancy (TSBPA). If you score below 70, you will receive a letter with your grade. The answers for this exam will be posted in the next issue of *Today's CPA*. Answers to last issue's self-study exam:
1. C 2. D 3. B 4. D 5. A 6. B 7. B 8. D 9. C 10. B

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(Please check one.) 5=excellent 4=good
3=average
2=below average 1=poor
1. The authors' knowledge of the subject is:
5__ 4__ 3__ 2__ 1__.
2. The comprehensiveness of the article is:
5__ 4__ 3__ 2__ 1__.
3. The article and exam were well suited to my background, education and experience:
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1 **In a typical sale-leaseback transaction, the seller sells an asset to the purchaser, yet retains the right for a long-term continued use of the asset through a leasing arrangement.**

A. True
B. False

2 **Companies enter into sale-leaseback transactions for which of the following reasons:**

A. Alternative financing
B. Tax consideration
C. Strengthening the balance sheet
D. All of the above

3 **When compared to a comparable collateralized loan, sale-leaseback transactions can provide more funds because the sale-leaseback allows the seller/lessee to raise cash for the full value of the asset.**

A. True
B. False

4 **Sale-leaseback transactions provide lessees with certain tax advantages such as:**

A. Lease payments are fully deductible in sale-leaseback transactions.
B. Sale-leaseback transactions can create capital gains and losses.
C. Both of the above.
D. None of the above.

5 **Under existing GAAP, the seller/lessee amortizes deferred profits and losses:**

A. for capital leases over the lease term or the leased items' economic life.
B. for capital leases in proportion to the rental payments over the period of asset use.
C. for operating leases over the lease term or the leased items' economic life.
D. None of the above.

6 **Under existing GAAP, sale-leaseback transactions can result in off-balance-sheet liabilities for the seller-lessee when the lease is classified as an operating lease. However, the lease ED would require that lessee recognize all leases on their balance sheets.**

A. True
B. False

7 **Under the proposed guidance, a seller/lessee would now apply revenue recognition standards to determine whether to recognize a sale of the underlying asset. If the sales recognition standards are met:**

A. The transaction could be accounted for as a sale and leaseback of the underlying asset.
B. The seller/lessee would de-recognize the underlying asset.
C. The seller/lessee would recognize a gain or loss immediately.
D. All of the above.

8 **When a seller/lessee has an unconditional *right* to repurchase the leased asset, this is considered a:**

A. Call option.
B. Forward rights
C. Put option
D. None of the above

9 **In the latest developments (June 2012), the Boards announced that they support a principle for classifying leases based on whether the lessee acquires and consumes more than an insignificant portion of the underlying asset over the lease term. As such, the Boards would support classifications for leases as either straight-line or accelerated depending upon the type of property.**

A. True
B. False

10 **As illustrated in Exhibit II of the illustration, the total effect on the seller/lessee's first year's expenses come from the following source/s:**

A. Amortization of the right-of-use asset
B. Interest on the lease liability and amortization of the right-of-use asset
C. Lease payments
D. Interest on the lease liability