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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Utilization of the Sale and Leaseback Transaction

The sale and leaseback transaction involves the sale of a fixed asset to an investor, with the fixed asset being leased back to the seller. Fixed assets in a sale and leaseback transaction may include equipment and improved real estate. This article will focus more on the area of sale and leaseback transactions relating to improved real estate.

There are benefits to both parties in a sale and leaseback transaction. The seller receives the proceeds of the fair market value of the property and still retains the use of the property, while at the same time the investor receives the tax benefit of depreciation and a guaranteed long term lease of the property. A sale and leaseback transaction will also improve a seller's financial ratios and reduce depreciation expense.

A sale and leaseback lease agreement will generally be for a period of at least 15 years with renewal options. The terms of the lease agreement will include a base amount of rent with increases or decreases in the rental amount based on such factors as changes in the Consumer Price Index. The base rate of rent will depend upon a number of factors, such as the general market conditions for the property and the financial strength of the seller as the lessee of the property. The lease payments are typically fixed to provide for amortization of the purchase price over the term of the lease, plus a specified return rate to the investor. Because a sale and leaseback transaction is not considered a loan, state usury laws do not apply. Generally, the lease agreement between the parties will be characterized as a triple net lease, meaning that the seller, as the lessee, will be responsible for all costs including insurance, taxes and maintenance.

In structuring a sale and leaseback transaction, it is important to make sure that the purchase price of the property is at fair market value. In this regard, as part of the transaction, the purchase price will be based on one or more appraisals as to the market value of the property. If the lease agreement contains a right of first refusal or option by the seller to purchase the property from the investor, it is important to make sure that this right of first refusal or option to purchase is premised on the fair market value at the time of this subsequent event.

In a sale and leaseback transaction the seller, as lessee, must comply with the accounting requirements of Financial Accounting Standards Board Statement No. 98 ("FASB Statement No. 98"). FASB Statement No. 98 does not permit a seller to have any continuing involvement in the transaction other than as a lessee. Under FASB Statement No. 98, lessee's continuing involvement would include, but not be limited to factors such as the seller being obligated for guaranteeing a portion of the investor's debt or seller making an equity investment in the investor.

In addition to the seller complying with the accounting requirements, the parties to a sale and leaseback transaction will want to be sure that the transaction complies with the technical requirements of the Internal Revenue Code. The landmark case dealing with the tax issues in a sale and leaseback transaction is *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). In this case, the Court looked at the economic realities of a transaction, rather to the particular form the parties employed. The Court evaluated the substance of the facts to determine that it should be treated as a sale and leaseback transaction, rather than a financing transaction, concluding that the transaction had genuine economic substance and was not shaped solely for tax avoidance. The Court pointed out that a sale and leaseback transaction will not be upheld unless the investor, as lessor, acquires and retains significant and genuine attributes of a traditional owner including bearing the risk of the lessee's nonpayment of rent. The investor's return was dependent on the property's value and the investor's equity investment was at risk if the property declined in value. The Court noted that the economic burden of any decline in the value of the property is integral to the determination of ownership for tax purposes.

Factors to consider before entering into a sale and leaseback transaction include:

- loss of depreciation by the seller;
- seller's expense of leasing the property on a long term basis;
- possible negotiation of a substitute property clause in the sale agreement in the event the seller discontinues use of the property in the future;
- income to be generated from the proceeds of the sale of the property;
- income derived from the capital gain, which gain is generally amortized over the life of the lease; and
- a built-in-gains tax on a Subchapter S corporation whenever an asset which has an unrealized gain at the date of conversion is sold during the ten-year period following the conversion from a C corporation.

When properly structured, the sale and leaseback transaction provides the seller with an excellent opportunity for increasing capital, funding acquisitions and stock repurchases, and providing funds for internal growth while at the same time providing the investor with tax benefits and a guaranteed return on its investment.

Our firm is available to answer questions on the benefits of a sale and leaseback transaction and the utilization of an investor for accomplishing the goals to be derived from the transaction.

Consolidation in Banking

The banking industry continues to consolidate throughout the United States. Consolidation occurs from a number of factors, with banks experiencing loan portfolio problems resulting in inadequate capital on one hand and the pricing of banks in acquisition transactions on the other hand.

Recent published reports reveal that the average price on transactions in the first six months of this year had a price/book multiple of 2.38 and a price/earnings ratio of 27.17, as compared to transactions announced in the first six months of 2006, which had a price/book multiple of 2.35 and a price/earnings ratio of 25.87. The consolidation in banking continues, with the Federal Deposit Insurance Corporation reporting the number of insured institutions having declined over 40% since 1992.

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