35th Annual

Tax Symposium

SALE-LEASEBACKS: REAL ESTATE SALE, FINANCING TRANSACTION, OR TAX TRAP?

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ONE CLOSING CAN TELL THREE TAX STORIES

1

Real estate sale

Seller recognizes gain.
Buyer receives basis and depreciation.
Tenant deducts rent.

2

Financing transaction

Sale proceeds become loan proceeds. Payments become principal and interest.

3

Tax trap

Expected deductions, timing, or character fail after the underlying numbers are examined.

The result turns on who actually bears the burdens and receives the benefits of ownership.

WHY NOW: THE MATH HAS CHANGED

1

Mortgage rates have repriced

Conventional commercial mortgage financing costs have increased materially. For an owner-occupant, the implied cost of capital in a sale-leaseback is now often competitive.

2

100% of value, not LTV

A sale-leaseback monetizes the full fair market value of the property rather than a loan-to-value fraction, without adding traditional debt to the balance sheet.

3

OBBBA and Bonus depreciation

Permanent 100% bonus depreciation (OBBBA) on qualified property acquired after Jan. 19, 2025 makes cost-segregated §1245 components especially valuable to buyers

Sale-leaseback volume is rising because the deal terms now favor both sides of the table.

OWNERCO NEEDS LIQUIDITY, BUT NOT A MOVING TRUCK

OwnerCo

25-Year Manufacturing Facility

$5.0M Fair market value	**$1.5M** Adjusted tax basis
15 yrs Initial lease term	**8%** Target buyer return

- **Absolute triple-net lease**
- **Two 5-year renewals**
- **Repurchase option after year 15**
- **Implied annual rent of $400,000 (8% on $5M)**

The owner is approaching retirement and wants liquidity before transitioning the operating business.

THE SALE PRODUCES AN IMMEDIATE TAX BILL

Amount realized

$5,000,000

− Adjusted basis

$1,500,000

Taxable gain

$3,500,000

Character still matters

- **§1231 gain may receive capital treatment**
- **Unrecaptured §1250 gain reflects prior building depreciation**
- **§1245 components can create ordinary-income recapture**
- **Land, building, and shorter-lived assets require allocation. Blended federal tax: ~$700K–$1M+ (25% §1250, 20% cap gain, 37% §1245, 3.8% NIIT).**

THE TAX BENEFITS MOVE ACROSS THE TABLE

SELLER / TENANT

- Recognizes sale gain
- Stops depreciating the property
- Generally deducts ordinary rent
- Trades future appreciation for liquidity
- Bears increased recapture from aggressive allocation

BUYER / LANDLORD

- Takes a cost basis equal to purchase price
- Allocates basis to land and improvements
- Claims depreciation including bonus on §1245 components
- Reports rent and bears residual-value risk
- Pushes for aggressive §1245 allocation to maximize bonus

Allocation is a negotiated zero-sum term, not a post-closing accounting exercise.

OwnerCo: If buyer allocates $1.5M to §1245 → ~$180K additional federal tax vs. §1250 rates on the same dollars (to the extent OwnerCo previously depreciated those components as §1245 property).

THE BOOK ANSWER AND THE TAX ANSWER CAN DIVERGE

TAX TREATMENT

- Completed sale under benefits-and-burdens doctrine
- Seller recognizes gain; buyer takes cost basis
- Rent payments deductible as incurred
- Asset removed from seller's depreciation schedule

BOOK TREATMENT (ASC 842)

- Failed sale if control does not transfer under ASC 606 (e.g., repurchase option) or the leaseback is a finance lease.
- Asset remains on seller's balance sheet
- Proceeds recorded as a financing liability
- Affects loan covenants and deferred-tax accounting

OwnerCo's repurchase option likely defeats sale accounting unless exercisable only at then-prevailing FMV and alternative assets are readily available—a condition a special-purpose manufacturing facility rarely satisfies.

TAX OWNERSHIP FOLLOWS THE FINANCIAL SUBSTANCE

1. **Possession and control**
2. **Risk of loss**
3. **Obligation to insure**
4. **Duty to pay taxes**
5. **Capital-improvement burden**
6. **Appreciation opportunity**
7. **Residual value**
8. **Right or obligation to repurchase**

Not equally weighted. Residual value and the repurchase option carry the most analytical weight.

Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Sun Oil Co. v. Commissioner; Hilton v. Commissioner. Courts continue applying this multi-factor test with particular scrutiny on genuine economic risk.

No single factor controls. The entire arrangement is tested as one transaction.

OWNERCO'S RISK INCREASES, BUYER'S RISK DISAPPEARS

MORE SALE-LIKE

- Independent appraisal
- Market rent
- Meaningful buyer equity
- FMV repurchase option
- Genuine residual exposure

MORE LOAN-LIKE

- Rent tracks debt service
- Nominal purchase option
- Lease consumes useful life
- Specialized single-user property
- Predetermined buyer return

OwnerCo's long term, absolute net obligations, and repurchase right demand careful drafting.

RECHARACTERIZATION REWRITES BOTH SIDES' RETURNS

DOCUMENTED		RECHARACTERIZED
Purchase price	→	Loan proceeds
Rent	→	Principal + interest (interest subject to §163(j))
Seller recognizes gain	→	No current sale; gain reversed for open years
Buyer depreciates	→	Seller remains the tax owner; continues depreciating the building.
Buyer reports rent income	→	Buyer reports interest income only

When recharacterized, every line item changes for both parties.
The documented transaction is unwound.

OwnerCo: the $3.5M gain was never realized; rent recast as principal and interest; buyer loses its $5.0M basis.

§163(J): THE INTEREST LIMITATION

AS RENT		AS INTEREST
Fully deductible	→	Subject to 30%-of-ATI cap
Ordinary bus. deduction	→	Aggregated with all business interest
No ATI limitation	→	Disallowed amounts carry forward
Current-year deduction	→	Indefinite carryforward, no current benefit
Predictable cash flow	→	Cash/deduction mismatch

§163(j): Rent is generally fully deductible. Recharacterized interest is subject to the 30%-of-ATI limitation and aggregated with OwnerCo's other interest expense. Disallowed amounts carry forward indefinitely.

OwnerCo: $3.5M gain never realized (refund only for open years); ~$400K annual rent recast as interest subject to 30%-of-ATI cap; interest aggregated with all other business interest expense.

§467: THE RENT SCHEDULE AS A TAX TERM

WHEN §467 APPLIES

Real property lease with increasing/decreasing rent or prepaid/deferred rent where total rent exceeds $250,000. OwnerCo clears this threshold many times over.

ORDINARY CONSEQUENCE

Constant-rental or proportional-rental accrual plus interest on deferred balances. Cash and deductions diverge but the schedule is determinable.

PUNITIVE CONSEQUENCE

A disqualified leaseback or long-term agreement mandates constant rental accrual leveling the present value of all rent across the term. Sale-leasebacks are named in the statute; the leaseback prong applies regardless of term length

Run the §467 analysis before the rent schedule is fixed. CPI-based escalators or rent within the ±10% uneven rent band are safe harbors; fixed bumps over a long term need a documented business reason.

A rent holiday, annual escalations, or a deferral puts §467 in play.

UNCAPPING, TRANSFER TAXES, AND INCENTIVE SURVIVAL

1 Proposal A uncapping

A sale-leaseback is a transfer of ownership that uncaps taxable value. After 25 years, the gap between capped taxable value and 50% of true cash value can be very large. Uncapping resets taxable value to SEV the following year.

2 Triple-net pass-through

Under an absolute triple-net lease the property tax increase flows straight through to OwnerCo as additional rent for the life of the lease. No exemption covers a sale-leaseback of this kind.

3 Transfer taxes

State and county real estate transfer taxes apply at the time of sale. These are a closing cost that must be modeled in the seller's net proceeds.

4 Incentive survival

Any industrial facilities exemption (IFT), PA 198 abatement, or Renaissance Zone benefit must be checked for survival on change of ownership. Loss of an abatement can materially increase ongoing property tax costs.

Model the full post-closing property tax burden before the LOI is signed.

A RESPECTED SALE CAN STILL CONTAIN A TAX TRAP

1 Repurchase options

A bargain or effectively nominal option undermines residual ownership and can trigger recharacterization of the entire transaction.

2 Related parties

§§267, 707, and 1239 can disallow losses, recharacterize gain, or change the character of payments between related persons.

3 Recapture

Cost-segregated components may produce ordinary income under §1245, not the capital gain the seller modeled. The allocation determines the exposure.

4 Lease and occupancy risk

Foreclosure, bankruptcy, casualty, and assignment can threaten continued occupancy. Non-disturbance and attornment provisions are essential.

5 §1031 and QOZs

The leaseback interest retained by the seller is a disqualifying property interest. Like-kind exchange treatment is generally unavailable for sale-leasebacks. QOZ is a better option, but. . .

THE LOI IS ALREADY A TAX DOCUMENT

1. **Value**
   Independent purchase-price and rent support
2. **Allocate**
   Land, building, and §1245 components
3. **Model**
   Seller, tenant, buyer, and state/local outcomes
4. **Draft**
   Term, options, capital obligations, residual risk
5. **Verify**
   Financing, title, incentives, non-disturbance

BEFORE ANYONE SIGNS

- **Is there a business purpose beyond tax savings?**
- **Are price and rent independently supported?**
- **Does the purchaser retain real upside and downside?**
- **Will the repurchase price reflect future FMV?**
- **Do appraisal, model, lease, and return tell one story?**

Do this before the deal terms harden into a signed term sheet.

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QUESTIONS

Submit questions for presenters

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THANK YOU



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