SOLD BUT STILL THERE:
THE TAX SIDE OF SALE-LEASEBACKS:
REAL ESTATE SALE, FINANCING TRANSACTION, OR TAX TRAP?

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I. INTRODUCTION: ONE CLOSING CAN TELL THREE TAX STORIES

A. The same documents can support three different tax outcomes

1. Real estate sale

   a. Seller recognizes gain.

   b. Buyer receives basis and depreciation.

   c. Tenant deducts rent.

2. Financing transaction

   a. Sale proceeds become loan proceeds.

   b. Payments become principal and interest.

3. Tax trap

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

B. Controlling principle: the result turns on who actually bears the burdens and receives the benefits of ownership.

II. WHY NOW: THE MATH HAS CHANGED

A. Mortgage rates have repriced

1. Conventional commercial mortgage financing costs have increased materially.

2. For an owner-occupant, the implied cost of capital in a sale-leaseback is now often competitive.

B. 100% of value, not loan-to-value

1. A sale-leaseback monetizes the full fair market value of the property rather than a loan-to-value fraction.

2. It does so without adding traditional debt to the balance sheet.

C. Permanent 100% bonus depreciation

1. The One Big Beautiful Bill Act (P.L. 119-21) permanently restored 100% bonus depreciation for qualified property acquired after January 19, 2025, replacing the TCJA phase-down.

2. Full first-year expensing makes cost-segregated § 1245 components especially valuable to buyers and drives aggressive allocation demands.

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

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III. CASE STUDY: OWNERCO

A. The facts

1. 25-year-old manufacturing facility

   a. Fair market value: $5.0 million.

   b. Adjusted tax basis: $1.5 million.

2. Lease terms

   a. 15-year initial term on an absolute triple-net lease with two 5-year renewals.

   b. Repurchase option after year 15.

   c. 8% target buyer return, implying annual rent of $400,000 (8% of $5.0 million).

3. Business objective: the owner is approaching retirement and wants liquidity before transitioning the operating business.

B. The sale produces an immediate tax bill

1. Amount realized of $5,000,000 less adjusted basis of $1,500,000 produces taxable gain of $3,500,000.

2. Character still matters

   a. § 1231 gain may receive capital treatment.

   b. Unrecaptured § 1250 gain reflects prior building depreciation.

   c. § 1245 components can create ordinary-income recapture.

3. Land, building, and shorter-lived assets require allocation.

4. Blended federal tax of roughly $700,000 to more than $1 million (25% § 1250, 20% capital gain, 37% § 1245, and 3.8% NIIT).

C. The tax benefits move across the table

1. Seller/tenant

   a. Recognizes sale gain and stops depreciating the property.

   b. Generally deducts ordinary rent and trades future appreciation for liquidity.

   c. Bears increased recapture from an aggressive allocation.

2. Buyer/landlord

   a. Takes a cost basis equal to the purchase price and allocates basis to land and improvements.

   b. Claims depreciation, including bonus depreciation on § 1245 components.

   c. Reports rent, bears residual-value risk, and pushes for an aggressive § 1245 allocation to maximize bonus.

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

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a. OwnerCo: if the buyer allocates $1.5 million to § 1245 property, OwnerCo pays roughly $180,000 in additional federal tax compared to § 1250 rates on the same dollars (37% versus 25%), to the extent OwnerCo previously depreciated those components as § 1245 property.

IV. THE BOOK ANSWER AND THE TAX ANSWER CAN DIVERGE

A. Tax treatment

1. Completed sale under the benefits-and-burdens doctrine; the seller recognizes gain and the buyer takes a cost basis.

2. Rent payments are deductible as incurred, and the asset is removed from the seller's depreciation schedule.

B. Book treatment (ASC 842)

1. Failed sale if control does not transfer under ASC 606 (for example, because of the repurchase option) or the leaseback is a finance lease.

2. The asset remains on the seller's balance sheet, and the proceeds are recorded as a financing liability.

3. Affects loan covenants and deferred-tax accounting.

C. OwnerCo application

1. The repurchase option likely defeats sale accounting unless it is exercisable only at then-prevailing fair market value and alternative assets are readily available.

2. A special-purpose manufacturing facility rarely satisfies that condition.

V. TAX OWNERSHIP FOLLOWS THE FINANCIAL SUBSTANCE

A. The benefits-and-burdens factors

1. Possession and control; risk of loss; obligation to insure; and duty to pay taxes.

2. Capital-improvement burden; appreciation opportunity; residual value; and right or obligation to repurchase.

3. The factors are not equally weighted; residual value and the repurchase option carry the most analytical weight.

B. Authorities

1. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Sun Oil Co. v. Commissioner*, 562 F.2d 258 (3d Cir. 1977); and *Hilton v. Commissioner*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982).

2. Courts continue applying the multi-factor test with particular scrutiny on genuine economic risk.

3. No single factor controls; the entire arrangement is tested as one transaction.

C. Sale-like versus loan-like indicators

1. More sale-like

a. Independent appraisal, market rent, and meaningful buyer equity.

b. Fair market value repurchase option and genuine residual exposure.

2. More loan-like

   a. Rent tracks debt service, a nominal purchase option, and a lease that consumes the useful life.

   b. Specialized single-user property and a predetermined buyer return.

3. OwnerCo's risk increases while the buyer's risk disappears; its long-term, absolute net obligations, and repurchase right demand careful drafting.

VI. RECHARACTERIZATION REWRITES BOTH SIDES' RETURNS

A. Documented versus recharacterized

1. Purchase price becomes loan proceeds.

2. Rent becomes principal and interest, with the interest subject to § 163(j).

3. No current sale occurs; the seller's recognized gain is reversed for open years.

4. The seller remains the tax owner and continues depreciating the building, and the buyer reports interest income only.

5. OwnerCo: the $3.5 million gain was never realized, rent is recast as principal and interest, and the buyer loses its $5.0 million basis.

B. § 163(j): the interest limitation

1. Rent is generally fully deductible; recharacterized interest is subject to the 30%-of-ATI cap.

2. Recharacterized interest is aggregated with all of OwnerCo's other business interest expense.

3. Disallowed amounts carry forward indefinitely with no current benefit, creating a cash/deduction mismatch.

4. OwnerCo: a refund on the $3.5 million gain is available only for open years, and roughly $400,000 of annual rent is recast as interest subject to the cap.

VII. §467: THE RENT SCHEDULE AS A TAX TERM

A. When § 467 applies

1. A real property lease with increasing or decreasing rent, or prepaid or deferred rent, where total rent exceeds $250,000.

2. OwnerCo clears this threshold many times over.

B. Consequences

1. Ordinary consequence: constant-rental or proportional-rental accrual plus interest on deferred balances; cash and deductions diverge, but the schedule is determinable.

2. Punitive consequence: a disqualified leaseback or long-term agreement mandates constant rental accrual, leveling the present value of all rent across the term.

C. Planning points

1. Sale-leasebacks are named in the statute; a 15-year lease with two 5-year renewals on a 39-year building is the target fact pattern.

2. CPI-based escalators, or rent within the ±10% uneven rent band of Treas. Reg. §1.467-3(c), fall within a safe harbor; fixed 2–3% escalators over a long term generally do not and need a documented business reason.

3. A rent holiday, annual escalations, or a deferral puts §467 in play; run the §467 analysis before the rent schedule is fixed.

VIII. UNCAPPING, TRANSFER TAXES, AND INCENTIVE SURVIVAL

A. Proposal A uncapping

1. A sale-leaseback is a transfer of ownership that uncaps taxable value.

2. 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.

B. Triple-net pass-through

1. Under an absolute triple-net lease, the property tax increase flows straight through to OwnerCo as additional rent for the life of the lease.

2. No exemption covers a sale-leaseback of this kind.

C. Transfer taxes

1. State and county real estate transfer taxes apply at the time of sale and must be modeled in the seller's net proceeds.

D. Incentive survival

1. Any industrial facilities exemption (IFT), PA 198 abatement, or Renaissance Zone benefit must be checked for survival on a change of ownership.

2. Loss of an abatement can materially increase ongoing property tax costs; model the full post-closing property tax burden before the LOI is signed.

IX. A RESPECTED SALE CAN STILL CONTAIN A TAX TRAP

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

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

C. Recapture: cost-segregated components may produce ordinary income under § 1245, not the capital gain the seller modeled; the allocation determines the exposure.

D. Lease and occupancy risk: foreclosure, bankruptcy, casualty, and assignment can threaten continued occupancy; non-disturbance and attornment provisions are essential.

E. § 1031 and QOZs

1. The leaseback cannot serve as replacement property, and a leaseback of 30 years or more risks unintended exchange treatment; a § 1031 exchange into other property is possible but defeats the liquidity goal.

2. A Qualified Opportunity Zone investment is a better option, with limits: only capital gain and net § 1231 gain are eligible (not § 1245 recapture); it is an equity rollover into a fund, not an exchange of the building; and the full benefit requires a 10-year hold.

X. THE LOI IS ALREADY A TAX DOCUMENT

A. Five-step workflow

1. Value: independent purchase-price and rent support.

2. Allocate: land, building, and § 1245 components.

3. Model: seller, tenant, buyer, and state and local outcomes.

4. Draft: term, options, capital obligations, and residual risk.

5. Verify: financing, title, incentives, and non-disturbance.

B. Before anyone signs

1. Is there a business purpose beyond tax savings?

2. Are price and rent independently supported?

3. Does the purchaser retain real upside and downside?

4. Will the repurchase price reflect future fair market value?

5. Do the appraisal, model, lease, and return tell one story?

C. Bottom line: do this work before the deal terms harden into a signed term sheet.

XI. CONTACT INFORMATION

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