

The Colorado Springs Business Journal

SEPTEMBER 10, 1999

Synthetic leasing can help corporate America

By STEVE EPLING

Special Report for The Business Journal

In an era of increasing rental rates, every company is faced with the challenge of minimizing after-tax real-estate occupancy costs, generally the second or third-largest budgetary line item for most service companies. Public companies face an additional challenge — executing strategies which minimize the negative effects on their balance sheets of owning real estate.

The “synthetic lease” is a unique financing alternative which accomplishes both objectives. Although the synthetic lease concept has been in existence for a long time (used primarily to finance equipment), it has recently gained prominence as a real-estate tool for mainstream corporate America, particularly among explosive growth high-tech firms. Although the synthetic lease is appropriate for all firms, it is particularly attractive for high-tech firms — firms where Wall Street frowns heavily on investments outside their core businesses (where returns are significantly higher).

A synthetic lease is an off-the balance-sheet means of financing real estate or equipment so that it is treated as a capital transaction for tax purposes and as an “operating lease” under generally accepted accounting principles (GAAP). Therefore, the corporation realizes the federal tax advantages of owning real estate (the tax shield of depreciation and interest-expense deductions) while achieving favorable balance-sheet treatment under GAAP. By keeping the debt and real estate off the balance sheet, a corporation’s return on assets and debt ratios are improved, and higher earnings per share are achieved.

The synthetic lease is a complex transaction that must be carefully engineered jointly with your firm’s accountants to ensure that

upon completion, the lease is treated as an operating lease on the corporation’s financials. It is used generally for acquiring or developing new facilities, and not sale-leaseback transactions.

To qualify as an off-the-balance-sheet “operating lease” vs. a “capital lease,” the transaction must meet criteria established by the Financial Accounting Standards Board (FASB), which is the rule-making body of the accounting industry. FASB’s Statement of Financial Accounting Standards No. 13 establishes four tests for a lease to qualify as an operating lease.

■ The title cannot automatically transfer to the lessee at the end.

■ The purchase-price option amount cannot be a “bargain.”

■ The lease term cannot exceed 75 percent of the economic useful life of the property. Commercial real estate is depreciated based on a 39.5-year economic life.

■ The total minimum rental payments, discounted to a present value, cannot be equal to or greater than 90 percent of the fair market value of the property, as calculated at the inception of the lease.

To qualify as an ownership structure under IRS guidelines, the “owner” must realize the significant benefits and burdens of owning real estate. Benefits in a synthetic lease transaction are obtained by allowing the corporation to realize the property’s appreciation by the fixed-price option to buy the property at lease end. Burdens include the residual value guaranty if the property declines in value.

A synthetic lease transaction is structured by creating a special-purpose entity unrelated to the corporation (SPE/lessor) to purchase the property and enter into a lease with the corpo-

ration (the lessee). The property may be raw land or a completed or partially completed facility, and the synthetic lease can provide for construction or renovation to the lessee’s needs. The SPE generally invests at least 3 percent equity into the property and finances the balance (usually non-recourse to the SPE) based on the lease and the lessee’s credit, and not the underlying value of the real estate created.

The lease term is generally short (three to 10 years) to comply with FASB guidelines and lease payments (which are generally fully expensed) are based on the SPE’s debt service, the costs of owning and operating the real estate, and a negotiated rate of return on the SPE’s equity investment. At lease end, the lessee has the option — and not the obligation — to purchase the property at a previously negotiated fixed price (the “FPO”).

If the property declines in value, the lessee’s deficiency liability is limited to a previously negotiated amount (typically 90 percent of total cost). At lease end, the lessee can purchase the property with the FPO, cause the property to be sold to a third party (realizing either the gain or subsidizing the deficiency to the negotiated amount) or renew the lease, which would involve rolling over financing.

Synthetic leases carry a unique risk because there are no definitive accounting, IRS or SEC rules that guarantee these transactions will be recognized in the future. In the event of a negative ruling, one or more of the favorable aspects of the synthetic lease structure may disappear.

Stephen B. Epling is vice president and director of corporate services at Coldwell Banker Commercial Moore and Co., located in Greenwood Village, Colo. Contact him at (303) 409-6062.