

## The "Synthetic Lease": The Benefits Can Be Very Real. Too Good To Be True?

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Assume for a moment that you are the CEO or chief financial officer of an expanding business. You have outgrown your existing corporate headquarters or are in need of a new or additional plant or manufacturing facility. Financing the project internally is either impossible or would result in an unacceptable drain on needed company resources and cash flow. Borrowing to finance the project would have a very high cost in terms of interest expense and principal repayment, not to mention the adverse impact on the company's balance sheet and operating ratios through the addition of substantial debt and significant assets to its balance sheet.

Now assume that you learn that there exists a structure for financing and completion of the project that would:

- Keep the real estate asset and the accompanying mortgage liability off of the company's balance sheet.
- Eliminate depreciation charges against the earnings of the company for financial reporting purposes.
- Allow lease payments on the facility to be classified as a currently deductible operating expense.
- Avoid treatment of the transaction as debt for accounting purposes.
- Allow the company to depreciate improvements for tax purposes.
- Avoid the negative impact on accounting and performance ratios (*i.e.*, return on assets, return on equity, interest coverage ratios and earnings per share) that conventional financing would entail.
- Potentially allow for 100% financing of the project.
- Allow the company to maintain absolute control over the facility.
- Give the company the ability to realize on appreciation in the value of the facility through a fixed price purchase option.

Too good to be true? Not necessarily. Under appropriate circumstances, and with careful planning and documentation, these benefits may be available on an off balance sheet basis through the use of a "synthetic lease."

### **SYNTHETIC LEASE STRUCTURE**

Companies interested in developing improved commercial real estate, but concerned about the impact of such an acquisition on their balance sheet should consider the advantages that might be available if the purchase/improvement is structured using a synthetic lease. Generally speaking, a synthetic lease is a method of structuring the purchase or construction of improvements on commercial real estate as an off balance sheet operating lease for accounting purposes, and as a mortgage loan for tax purposes. A synthetic lease is characterized as an operating lease for financial accounting purposes. The company retains the tax benefits and operating control associated with ownership of the facility but, for accounting purposes, does not have to reflect the lease obligation as a liability or the leased property as an asset on its balance sheet. Rental payments are expensed annually on the company's income statement.

In a typical synthetic lease transaction, a bank or other capital source provides the funding for the real estate acquisition and the construction of the improvements. The financing entity then acts as the landlord and leases back to the company, usually on a triple-net basis, the land and improvements. The company then pays a rental equivalent (generally interest-only payments on the costs of acquisition and construction) back to the financing source. At the end of the lease term, which usually runs for a period of three to ten years, the company may either purchase the property at some pre-determined fair market value purchase price, sell the property to a third party, or renew the lease (in essence refinance the loan) at the then existing capital rates.

#### **TYPICAL USER OF A SYNTHETIC LEASE**

As a financing vehicle, the synthetic lease may not be for everyone. Synthetic leases are often times used by high tech companies and other businesses with significant R&D expenses and other day-to-day capital needs, public companies and other balance sheet sensitive businesses, drug store and supermarket chains, manufacturers, data processing centers, hospitals and other health care providers, and other businesses with specialized build out needs and the accompanying costs. Synthetic leases are usually limited to newly constructed properties. Given the increasing acceptance of synthetic leases as a financing tool, its uses are expanding and businesses which would not otherwise have been considered candidates for its use are utilizing it on an ever increasing basis.

#### **CONCLUSION**

The synthetic lease is a financing mechanism with many obvious benefits to the end user. These include enhanced financial ratios, the availability of tax benefits of real estate ownership, lower financing costs and greater financing flexibility and the ability of the end user to realize future appreciation in the value of the facility. Synthetic leases are, however, also highly complex and require careful advance planning, structuring and documentation and can entail relatively high transaction costs. Nonetheless, under appropriate circumstances, the synthetic lease structure can afford the user the benefits of real estate ownership without many of the burdens which normally accompany such ownership.

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