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Synthetic Leases and Tax Policy: The Post-Enron Proposal to Deny Tax Deductions to Synthetic Lessees

Gil Sandler

A proposal pending in Congress would, if enacted into law, deny tax deductions to companies that use certain types of off-balance-sheet financing vehicles, such as synthetic leases. In this article, the author examines the pros and cons of both the synthetic lease structure and the bill.

Background

The recent Congressional proposal to deny tax deductions to companies that use certain types of off-balance-sheet financing vehicles, such as synthetic leases, to finance real estate and equipment is yet another by-product of the financial markets' sudden realization that corporate America has hidden and misunderstood liabilities, many of which are more real than contingent.

In H.R. 3622, curiously entitled "The Emergency Worker and Investor Protection Act of 2002, Congressman Rangel (D-NY) and a host of other Democratic colleagues have laid down the gauntlet to discourage, if not outlaw, many of the Enronian artifices which delayed its fall from grace. Introduced on January 24, 2002, at the height of the media craze fueled by Congressional hearings into the Enron debacle, the bill recites its laudable goal of protecting captive workers' retirement plans, stuffed with company stock purchased at inflated prices, from greedy executive insiders. These executives, ably assisted by well-paid advisors, were widely believed to have misused off-balance-sheet financing structures to inflate earnings and stock prices, before bailing out, leaving co-workers plans frozen in a contrived plan blackout.

This legislative proposal, however, penetrates moves far beyond the laudable objectives of compelling "transparency" in financial disclosures, and punishing greed. It seeks to punish public companies for daring to lease-finance real estate under various off-balance-sheet structures, in which the company's financial obligation is treated as debt for tax, but not shown as debt on the company's books - often for entirely justifiable reasons. In most off-balance-sheet lease structures, the lessor is the owner for tax and accounting purposes. In the recently popularized synthetic lease, however, the lessee is the owner for tax purposes only, under established principles of tax analysis. The synthetic lease's divergence between tax and accounting treatment is based upon recognizable and justified differences between tax and accounting guidelines, and not as a subterfuge or tax avoidance scheme - in which Enron and its confederates seem to have also prospered.

The mechanism used in the bill is to treat the corporate lessee's synthetic lease "rent" obligation, which would normally be considered interest on indebtedness to the owner (the corporate lessee in the

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synthetic lease structure), as a "isqualified debt obligation..." under Internal Revenue Code Sec. 163 (1), para. (2).[1] No mention is made in the bill of the lessee's status as the tax owner of the leased property, and its entitlement to the depreciation deduction. Nor does the bill suggest that the company might otherwise be regarded as a lessee under a so-called "true lease," and thereby entitled to a rent deduction for the very same interest expense.

Currently, in a synthetic lease that meets the FASB 13 tests for operating lease treatment, the company is the lessee for financial reporting purposes under GAAP but is considered the owner of the leased property for tax purposes. This entitles the company to deduct from taxable income both interest expense - usually equal to rent under the lease -- and depreciation.

Popular Product: The Universal Popularity of the Synthetic

The synthetic lease has achieved remarkable popularity as a staple of major bank financial products to its creditworthy corporate customers. By some accounts, there may currently be more than $20 billion of synthetic lease obligations outstanding, and a much higher cost or value of properties financed under synthetic leases and another $10 Billion was probably being rolled over or in the process when Enron asked Wall Street.

In essence, the synthetic lease was devised to enable banks and other financial service companies to offer creditworthy bank customers short-term lease-financing options on a credit basis, without regard to the customary equity, loan-to-value ratios and duration requirements of the commercial real estate mortgage markets. Corporate borrowers would otherwise have bypassed that market in many cases and financed their "core" real estate acquisition and development projects with direct, on-balance-sheet loans and medium-term notes or long-term bonds. This enabled the banks to extend credit within their customary tenor -- a three to seven-year term - while permitting the company to obtain low-cost, non-amortizing funding without swelling its balance sheet with the real estate assets and corresponding debt incurred to finance these assets.

A typical synthetic lease involves a "build-to-suit" project or pool of projects in which the company, as lessee, designs the project, selects the contractors and assumes substantially all of the development and completion risk, subject to certain GAAP constraints on the shifting of risk from the lessor to the company.[2] After completion of the project, the lease becomes a credit-tenant or bond-type lease for a short term with financial covenants and credit pricing parameters identical to those found in bank term loans. The rents payable under the lease usually consist of interest only without amortization of principal,[3] which increases or decreases based on floating interest rate and credit pricing fluctuations.

These structural features suggest that, in a traditional tax analysis of anticipated economic benefits and burdens, virtually the entire risk and reward of the transaction rests with the lessee. Through the covenants and rent-reset mechanisms, the risk of a credit default or decline rests entirely with the lessee. The other main risk element - the residual value of the property at the end of the lease term - is also shifted to the company by means of a "residual value guarantee" ("RVG") or "contingent rent" obligation on the part of the lessee,[4] which usually obligates the company to purchase or find another purchaser to generate sale proceeds to retire the outstanding debt, or pay up to 85% of that amount.

The last major economic factor on the scale, the allocation of upside benefit, is vested entirely in the lessee by means of its purchase option, usually at the "unamortized lease investment balance" or other similar formula ensuring the lender of its return of capital. The lessor's nominal 3% equity contribution mandated by GAAP[5] is treated as a subordinated tranche of the bank loan, and yields a return based on interest rate targets, regardless of appreciation or depreciation of the leased property.

By contrast, in traditional real estate lease transactions, whether financed in the credit or the real estate markets, the lessor will bargain for and retain all or a portion of potential capital appreciation, depending on whether and how much equity risk has been required. Even credit-tenant-lease or CTL and institutional sale-leaseback transactions are sponsored by real estate investors who usually invest some risk equity seek long-term returns well above bank loan rates based on property appreciation.

What's Wrong With Synthetics?

The notion of synthetic products is not new. It took a while, but sophisticated consumers now cherish their synthetic fabrics for their durability, appearance, color retention and comfort. Chemical compounds, miracle drugs and synthetic materials are vital to the advancement of our information processing, telecom and electronics industries, although they were all originated in laboratories. Maybe "synthetic"-anything sounds strange, and special-purpose-entities or SPE's now seem scary, but SPE's are a well-established legal tool for the multi-trillion-dollar mortgage-backed securities and credit card securitization markets vital to insulate investors and lenders from the seller's bankruptcy risks. So, if a synthetic product - whether it's a financial structure using SPE's or a fabric -- serves a useful purpose, it should be evaluated on its own merits, and not be outlawed as an overreaction to a shocking abuse in other markets.

First, the negatives on synthetic leases: One primary criticism leveled at synthetics is that they assist the companies who "lease" the assets to hide the related liabilities, and the embedded, if deferred, costs of

maintaining the property off-balance-sheet. So long as the asset was held by an SPE whose only master was the company, which could effectively terminate the lease and recapture the asset at will, a strong case could be made that it should have been consolidated onto the company's books, and an FASB task force had worked for years to devise a suitable consolidation test. Many companies chose not to hide these assets or liabilities as such, and disclosed both the amounts and rents paid in relatively clear footnotes to their financial statements. The net result was that simple debt-to equity and return on asset ratios could be misleading, although rating agencies, banks and sophisticated investors were well aware of the structure and made appropriate adjustments in their analyses.

Another major, and seemingly valid, objection from a disclosure and analytic viewpoint is that the synthetic lease enables the company to understate its occupancy expense and overstate its net income. This result ensues from the omission from the company's P & L of any charge for depreciation on the building component of the real estate - because it is not the owner under GAAP - while its interest-only rent expense similarly excludes the amortization counterpart to depreciation. So long as the real estate does not decline in value, or the true depreciation charge on the building component is offset by land appreciation, no real harm may be done, and no FAS 121 impairment charge may be looming. Moreover, if the company's credit remains strong, it can presumably roll over the synthetic for an indefinite period, much as it would roll a credit market note or commercial paper. If, however, the company should encounter a serious credit decline, which triggers a lease termination and "rent" acceleration, at a time when the fair value of the property is below the unamortized balloon of debt and quasi-equity, the company could face a liquidity crunch, and investors may be in for an unwelcome surprise.

A third factor, which can be viewed as a negative, is that the company is virtually compelled to purchase or refinance the property being leased, because its residual value guarantee or RVG would be uneconomic for the company to absorb. Stated differently, a lessee would always opt to purchase or find another purchaser at a market price more or less than the outstanding debt, rather than pay the penalty of up to 85% of that debt and walk away from the property. This probable result requires that the RVG be recognized as the economic equivalent of a termination penalty or final rent payment in computing the FAS 13 90% test for operating lease classification. The counterpoint is that, so long as estimated future fair value for the property is equal to or more than the unamortized debt, there is no reason to expect that the property could not be sold without recourse to the RVG. This would also support the view that neither the real estate nor any corresponding debt incurred to acquire it needs to be recorded on the company's book's unless and until the liability exceeds the asset value, resulting in an actual or inevitable impairment charge, or anticipated loss upon purchase or sale to a third party.

Despite these legitimate criticisms, the synthetic lease often serves real economic objectives, totally unrelated to any sinister tax avoidance or nondisclosure motivation, and should be broadly distinguished from the callously abusive SPE's and off-balance-sheet structures exploited by Enron to conceal debt and its many high-risk failing ventures. Like other credit leases, synthetic leases enable creditworthy industrial, commercial and retail operating companies -- for whom real estate is a means and not an end -- to reduce one of their largest regular operating costs by obtaining both project and term financing in the credit markets. This avoids the higher costs and collateral constraints of the real estate mortgage and equity markets. Companies can often save on capitalized development and construction costs, as well as interest expense, if they control the development process, and eliminate the developer's lease-up risks.

Moreover, many growth-oriented companies are constantly building or acquiring properties for use in their operations. These may range from new retail "white box" superstores, distribution centers or customer call or data centers, to movie theater multiplexes. The synthetic lease gives them the flexibility of adjusting their operational locations from time to time to meet demographic shifts in their business model without giving up the normal appreciation of new development, or paying higher real estate rents to compensate for the lessor/developer having to pay a premium to finance in the real estate mortgage market against short or medium-term leases. If these properties do not represent core long-term assets[6] of the company, and their values amply support the company's rent and RVG exposures, there is no reason they should be capitalized on the company's balance sheet along with the debt incurred to build or acquire them. Fair markets may properly insist on better disclosure of contingent liabilities, and companies that hide impending Armageddons deserve to have their stocks downgraded. However, this should not cause operating lease accounting and dual tax and accounting analyses to be discarded like the proverbial "baby in the bathwater" merely because nothing different seems right after Enron.

The microscopic scrutiny focused on synthetics in recent weeks is simply the fallout from the Enron scandal, aggravated by other high-profile financial engineering misadventures. These included inventive games like: "Ring around the Channel Islands with the offshore Mahonia LLPs'" - circuitous make-believe energy supply contracts, brought to the media stage by Enron and its bankers; or Enron's "Save the Ruptured Raptors"; or the "roundtripping" exercises of the telceom giants - a virtual "Magical Mystery Tour" conducted around the globe by Global Crossing, Qualcomm, and others who structured - if not fabricated --uneconomic swaps of excess fiber-optic cable capac-

ity in order to inject new earnings at the end of a reporting period.

In fact, Enron had a "profit center" offering its pervasive financial engineering to prospective "cost-owners" of its various trading platforms. What permitted these artful dodgers to avoid showing earnings declines was liberal, if not downright senseless, accounting rules supported by FASB inaction that permitted immediate recognition of profits from a long-term lease swap of capacity, while deferring the matching costs. Even Enron's smaller crosstown survivor, Dynegy, who scoffed at its better known rival's death rattle, has now been exposed for using uneconomic partnership financing transactions to fabricate cash flow increases and accelerate tax deductions for paper losses and its credit and stock have been downgraded.

Simplistic conclusions aside, the common denominator of all of these deceptive, if not outright fraudulent, transactions is not the use of an SPE, offshore or off-balance-sheet entity, but the manipulation of accounting and tax rules to elevate form over economic substance. Much of the so-called trading of derivative products created in the energy and other non-financial sectors was never about truly locking up supply at favorable prices, but booking profits today based on subjective projections of long-term costs in future. When executive compensation in high-profile public companies is so dependent on stock prices, reported earnings are worshipped as if they were real, and it should come as no surprise to learn that financial executives, bankers and auditors have combined to blend fiction into reality, in the hope that future events will make the distinction immaterial, or that it will be obscured until after they have been able to bail out and move on. HR 3622 would be fully justified if it were redirected solely at such gross fabrications.

Not to be outdone - or overrun -- by Congressional zealots, the accounting profession seems to have taken the "wake-up call." Distancing themselves from Andersen's Enron team, other Andersen partners and the other Big 5, soon to be Big 4, audit firms began to recheck their synthetic lease and other off-balance-sheet structures. This review produced material financial restatements for Dollar General and PG&E, among others, and persuaded Krispy Kreme to forego or defer a synthetic lease on a core production facility. Other regular synthetic lease customers put their new deals on hold as the FASB, fearful of governmental regulation, announced new moves to formalize a long overdue consolidations rule, and a more substantive equity requirement for SPE lessors in the range of 10%.[7] Still other large users of synthetic lease have chosen to repurchase the properties with available cash or on-balance-sheet financing, all in the interest of providing "transparency" to the financial markets. Whatever the result, it seems clear that the solutions to any abuses in synthetic leases lay in appropriate disclosure of risks, and not in the elimination of operating lease treatment by accounting changes, or the denial of basic tax deductions, as proposed by HR 3622.[8] It is obviously late in the game, but FASB and the SEC are finally moving to promulgate meaningful rule changes.

The Tax Perspective

HR 3622's sponsors are attempting to enact a major tax law change in order to impose their understandable view of fair disclosure and reporting symmetry, with the apparent support of a Congress that is visibly shaken and angered. Unfortunately, many of our well-intentioned legislators seem not to have been sufficiently well-informed about the differences between synthetic leases and other complex financing structures designed to conceal real liabilities or fabricate earnings. The public outcry, fueled by the financial media's fascination with Enron and Andersen[9] at the hub of an "axis of evil," demands invites some visible curtailment of imploding off-balance-sheet vehicles, among other devices. In this endeavor, tax policy can be a useful tool, but its application to synthetic leases seems misplaced.

Our view is that, unless an important policy objective cannot be achieved without tax input, tax laws should serve tax purposes. Historically, tax laws have been invoked to direct capital investment towards job creation or technology advancements, and a host of other economic goals, but these means have usually been necessary to supplement or replace other, less efficient vehicles for change. Yet, it is clear from the totality of HR 3622 that Congress is seeking primarily, if not exclusively, to change the financial reporting and disclosure rules, rather than using the tax laws to ensure a fair allocation of tax burdens.

The synthetic lease is merely one of many anomalies in accounting or regulatory treatment, which have their own independent objectives, apart from tax treatment. Neither the synthetic lease, nor any of the myriad hybrid structures which have differing tax and accounting treatment, bear any resemblance to tax avoidance schemes. In the synthetic lease, there is no net gain or loss to the Treasury, or shifting of deductions from a low to a high-bracket taxpayer. Nor is there any effort to escape tax scrutiny or move tax-generating events or entities to an offshore "tax haven" with advantageous tax treaties or to allow multiple entities to use the same tax loss as an offset against taxable income. Rather, the declaration of who is the tax owner of properties financed through synthetic leases, or who receives the interest paid or depreciation deductions normally assigned to the tax owner,[10] is largely inconsequential from a tax perspective. This is evident from a few real-world examples of the primary leasing and financing options available to corporate users of real estate.

Take a $200 MM pool of development projects for XYZ Corp., a major "A"-rated Fortune 1000 retailer. These projects might include retail superstores or distribution centers or both. The company's usual financ-

ing options would include: (A) a 20-year credit-tenant lease pool with a developer/REIT/investor with a fixed rent of, perhaps, 9% of the project cost or $18 MM; (B) a direct five, seven or 10-year medium-term unsecured note at a rate of 6% to 7%; or (C) a synthetic lease with a major bank-affiliated lessor, which contributes 3% equity and borrows the 97% from a group of its relationship banks for an equivalent term at a fixed rent (swapped from floating LIBOR) of 6% to 7%.

In Case 1, XYZ would deduct its rent of $18 MM annually, and the lessor, if taxable, would receive $18 MM of taxable income and deduct a declining interest component of its 75%-90% mortgage financing, plus depreciation of 1/39th of the estimated 90% building component.[11] If the lessor is or includes as a limited or joint venture partner a tax-exempt pension fund, and the project is financed primarily with equity, the Treasury gets no tax revenue from the lessor. If the lessor is a REIT, the taxable income is distributed and passed through to its investors, many of whom are tax exempt funds. Even if the lessor were a fully taxable developer/investor, it would invariably have used a leveraged financing with limited amortization, so its taxable rental income would be sheltered in the early years by interest expense, and its mortgage would be periodically refinanced to maximize the interest deduction. If the refinancing market is more restrictive, and substantial amortization beyond cumulative depreciation appears imminent, the lessor can always arrange a Sec 1031 exchange. In either event, it is unlikely that the Treasury will find taxable income to match the rent deduction in Case 1.

In Case 2, the direct financing option, XYZ has an interest deduction of $12 MM to $14 MM annually, corresponding to interest income received by the note purchasers, many of whom are tax-exempt funds, so the net result is break-even at best for the Treasury, and maybe less, to the extent the interest income is tax-exempt. XYZ also gets the depreciation deduction, since it is the owner for tax purposes, as well as under GAAP. This could be a fair match for Treasury, but only to the extent that the interest income is received by taxable investors.

In Case 3, the synthetic lease, XYZ is deemed to be the owner of the property for tax purposes, so it gets to deduct the same $12 to $14 MM annually as interest expense, instead of rent. On the income side, the bank-affiliated lessor and lending banks all receive interest income as lenders, and since the banks are usually full taxpayers, the Treasury gets its pound of flesh to offset XYZ's deductions. The net effect on XYZ is substantially the same as if it had issued a term note and owned the property under GAAP. XYZ also gets the same depreciation deduction based on IRS useful life schedules of building component, just as in Case 2. Since our lenders are nearly always full taxpayers, the end result is likely to be a better match of taxable income and deductions than in Case 2, in which XYZ gets the same deductions.

Thus, it seems clear that a synthetic lease is, for the most part, tax-neutral, and not an undeserved tax windfall for either the company lessee or the lender/lessor. If HR 3622 were to become law, and the synthetic lessee were denied a deduction for interest expense, it is unclear whether they would receive instead a rent deduction, or still retain their status as owners, without deductions for either interest expense or rent. If the latter, they would be forced to borrow at higher rates in the mortgage markets or increase their direct, on-balance-sheet borrowings in the credit markets, even for properties that are not long-term, essential assets. Equally likely is the prospect that many of the companies forgoing synthetic leases would continue to lease their non-core properties, but would be pushed into developer leases. This would increase both their operating costs, and tax deductions for rents, while the lessors would either receive their usual interest and depreciation deductions to offset rental income, or be tax-exempt owners. The end result could well be a net reduction in tax revenue to the Treasury as an unintended effect of the proposed legislation.[12]

Conclusion

HR 3622 is clearly designed to regulate the disclosure and financial reporting of companies, with tax penalties thrown into the pile as an enforcement club. For many of these companies, synthetic leases are a cost-effective, economically viable financing approach. This task is best left to the SEC and FASB, who have the ability to consider many reporting and classification options consistent with other disclosure enhancements. Alterations to the basic synthetic lease structure are likely to result from both new disclosure rules and the move towards more consistent GAAP and tax treatment under unified international accounting practices.[13] Unlike these changes, the tax proposal in HR 3622 seems designed to tax synthetic leases and other hybrid structures out of existence without either a beneficial tax effect, or a reasoned effort to preserve economically valid lease structures.

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[1] The bill reads, in pertinent part, as follows:

"SEC. 3. DENIAL OF DEDUCTION FOR PAYMENTS ON DEBT INSTRUMENTS NOT INCLUDED AS LIABILITIES FOR PURPOSES OF SHAREHOLDER REPORTING.

(a) In General. Paragraph (2) of section 163(l) of the Internal Revenue Code of 1986 (relating to disallowance of deduction on certain debt instruments of corporations) is amended to read as follows:

(2) Disqualified debt instrument. For purposes of this subsection, the term 'disqualified debt instrument' means--

(A) any indebtedness of a corporation which is payable in equity of the issuer or a related party, and

(B) in the case of an SEC registrant--
(i) any indebtedness of such registrant if such indebtedness is not shown in the certified annual report as part of the total liabilities of such registrant, and (ii) any indebtedness of an off-balance-sheet entity if the proceeds from the issuance of such indebtedness are used directly or indirectly to acquire stock (or other ownership interest) in such registrant."
(b) Definitions. Subsection (l) of section 163 of such Code is amended by redesignating paragraph (5) as paragraph (8) and by inserting after paragraph (4) the following new paragraphs:

(5) Certified annual report. For purposes of this subsection, the term 'certified annual report' means, with respect to any taxable year, any annual report (or financial statement) covering all or part of such taxable year--

(A) which is required to be filed with the Securities and Exchange Commission, and
(B) which is required to be certified by an independent public accountant.

(6) SEC registrant. The term 'SEC registrant' means--
(A) any corporation which is required to file a certified annual report with the Securities and Exchange Commission, and
(B) any other entity the assets and liabilities of which are consolidated with a corporation described in subparagraph (A) for purposes of such a report.

(7) Off-balance-sheet entity. For purposes of this subsection, the term 'off-balance-sheet entity' means, with respect to any SEC registrant, an entity in which such registrant holds an ownership interest if--

(A) the assets and liabilities of such entity are not consolidated as part of the assets and liabilities of the registrant for purposes of such registrant's certified annual report, and
(B) for purposes of this title, such entity is treated as a partnership or trust or is disregarded as an entity separate from its owner pursuant to regulations issued by the Secretary.

(c) Effective Date. The amendments made by this section shall apply to instruments issued after the date of the enactment of this Act."

[2] EITF 97-10 contains a separate "90% test," similar to that of FASB 13, Para. 7, limiting the lessee's risk during the construction period, and precludes the lessee from directly absorbing "force majeure" risk.

[3] Occasionally, banks may require some amortization for longer-term leases and special-purpose property leases with unusual residual value risk , but this is the exception.

[4] The RVG typically requires that the lessee pay an additional sum in the form of "contingent rent" up to approximately 85% (subject to adjustment based on the lease term and the "90% test" of FASB 13) of the original cost of the property if the property is not purchased or refinanced at the end of the lease at an amount sufficient to repay the lessor/lender.

[5] EITF 90-15 essentially requires that non-substantive lessors, such as special purpose entities used as lessors, known as SPE's, be capitalized by at least 3% equity. Under EITF 96-21, this equity must remain at risk for the duration of the lease, and if borrowed by the lessor, must be supported by net assets at least equal at all times to the amount borrowed.

[6] Many companies have used synthetic leases to finance headquarters, manufacturing facilities, and other "core assets." Although these companies will usually take advantage of the GAAP benefit of avoiding a fixed depreciation charge to earnings, they will often take internal reserves against anticipated depreciation in values, and if the property is able to appreciate or retain its value, no impairment charge or deferred cost is required. Also, core assets often receive the benefit of regular capital improvement programs which are expensed annually in lieu of depreciation charges and which tend to maintain values at or above original cost.

[7] Although a formal proposal had not been released for comment at the time this article went to press, the FASB Board Meeting of February 27, 2002 announced a consensus to amend FASB Statement No. 94 to require consolidation of an SPE by its "Primary Beneficiary when the SPE lacks sufficient independent economic substance." The Board went on to note that: "[A]n SPE is considered to have that ability (i.e., to fund or finance its operations without assistance from or reliance on the Primary beneficiary] if its owners(s) is an independent third party that has:

- A substantive equity investment at risk in the SPE
- Substantive risks and potential rewards of ownership of the SPE
- The ability to make decisions about and manage the SPE's activities to the extent those decisions have not been predetermined for the SPE."

[8] Aside from the improbability of passage in its present form, the proposed bill leaves unanswered the important issues of whether the lease would be treated as a loan or a capital or operating lease for tax purposes. Since a synthetic lessee would not tolerate losing both a rent deduction and an interest deduction for "disqualified debt," the likely result is the replacement of synthetic leases with "true leases." In this lease scenario, the company is a lessee for tax purpose and receives a rent deduction, while the owner/lessor deducts depreciation and interest expense.

[9] Both of these giants have crumbled. Enron is liquidating assets, after taking a $14 Billion writedown. Andersen, unable to quickly settle criminal and civil proceedings, failed to meet former Fed Chair Volcker's rescue plan conditions, and is being dismantled by partner and group defections.

[10] The tax ownership determination usually involves a balancing of the risks and rewards of ownership. If the party who was the owner for tax purposes chooses to sell a property, but does not transfer sufficient risks and rewards of the type and magnitude normally associated with ownership, as distinct from those of a lender, there may not be a "sale" for tax purposes, and the transaction may not trigger taxable gain or loss. This concept is used in certain sale-leaseback structures like TNSLsm to avoid a taxable gain on the sale of appreciated property. Conversely, in the synthetic lease, there is no "sale" for tax purposes if the lessee buys the property, but the lessee may be liable for cumulative depreciation if the property is sold by the lessor to a third party at the end of the lease, because the lessee was the tax owner.

[11] For simplicity, the examples refer to the building components having a 39-year straight-line depreciation schedule, although most such projects will include equipment with shorter tax lives and depreciation schedules.

[12] As previously noted, because both the synthetic lessee and lessor are taxpaying entities, taxes are paid on both business and interest income, after no more than usual interest and depreciation deductions. In addition, if and when a synthetic lessee refinances an unamortized synthetic lease with a conventional developer/investor lease, rather than taking it onto its balance sheet, a taxable sale occurs, triggering a taxable gain to the extent of cumulative depreciation.

[13] Although beyond the scope of this article, the author believes that these imminent changes in accounting and disclosure policy will bring into focus other lesser-known credit lease structures, which preserve many of the cost and structural benefits of the synthetic lease.