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SYNTHETIC LEASES RETURN AFTER FASB 842

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FASB 842 Lease Accounting Rules which directly impact a tenant's balance sheet and finances was initially thought to put synthetic leases on life support… but not so fast!

A synthetic lease is a financing structured to be an operating lease for the tenant's accounting purposes and a financing for tenant's U.S. federal tax purposes. Historically synthetic leases served a role in the acquisition or construction of corporate headquarters or large expansion projects without utilizing corporate debt availability or capital at possibly more advantageous rates while the tenant has the benefit of depreciation deductions and deductions for the interest portion of rent payments. Prior to 2003, for some companies, off-balance sheet treatment was even more significant.

From the landlord's perspective, the synthetic lease is a credit transaction with a low risk tenant where the tenant has the construction and operating risks. Over time the "landlords" have morphed into being the tenant's lender/mortgagee or an affiliate of the lender. Negotiating the principal terms, structuring rent payments and negotiating options at expiration of the lease term are the challenges of a synthetic lease and issues applicable to "standard" operating leases are not as significant.

Since 2003, when FASB implemented FIN 46 (restricting use of an SPE as "landlord"), the market for synthetic leases had declined significantly. In an ironic twist, FASB 842's elimination of off-balance sheet treatment may be generating the renewed interest in synthetic leases for investment grade companies.

So what happens now… The market place operates as synthetic leases offer flexibility:

– Under FASB 842 the synthetic lease, like the operating lease, will be capitalized and included in calculation of financial covenants – the property being a "Right to Use Asset" but may have more beneficial treatment than ownership or a "standard" operating lease.

– Tenant and landlord must have strong credit quality.

– Tenant may be able to negotiate an interest only hedged rate or a favorable amortization schedule reducing monthly lease payments and preserving cash flow.

– Synthetic lease may not interfere with or require consent under company's corporate debt facilities.

- Synthetic lease can provide up to 100% of the cost of the property – not limited by lending ratios.
- Tenant has benefit of depreciation.
- Accountants use FASB 840’s (synthetic lease standards) bright line tests when characterizing new lease standards under FASB 842.
- 2017 Tax Cut and Job Act changes of leasing/financing provisions may create further tax incentives for tenant’s properties placed in service before July 1, 2023.
- Couple these benefits with a property located in the newly identified Opportunity Zones, then benefits to the tenant may multiply.

Because of the sophistication of synthetic leases, transaction costs for synthetic leases will most likely exceed costs associated with “standard” operating leases or straight financings, as accounting, legal and tax issues are more acute in order to achieve the intended results.