

SYNTHETIC DEBT

Off-Balance-Sheet Corporate Finance for the 21st Century

by

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EXECUTIVE SUMMARY

Off-balance-sheet fixed-income financial obligations can arise in an efficiently regulated market environment. Recent advances in financial technology have resulted in a class of lease-based fixed-income products to finance off-balance-sheet corporate acquisitions of tangible assets. Such products as synthetic leases and synthetic debt enable corporations to lease assets and also benefit from any increase in asset valuation while the assets are under lessee control. Synthetic lease finance imposes a number of constraints in return for the off-balance-sheet benefit. By contrast, synthetic debt finance provides corporate financiers with cost and flexibility comparable to conventional senior corporate debt.

INTRODUCTION

When publicly traded corporations incur financial obligations to raise investment capital, corporate officers evaluate available alternatives from several perspectives. This usually includes evaluation of the alternatives from both sell-side and buy-side perspectives: sell-side perspectives on how each alternative is expected to impact stock price and constrain operations, and buy-side perspectives on marketplace receptivity to each proposed obligation and expected pricing.

In the case of the lease-versus-debt alternative for finance of real estate and equipment acquisitions, the sell-side perspective reduces to a comparison of tax accounting and financial accounting treatments of the alternatives. The buy-side perspective reduces to an examination of expected buy-side perceptions of financier investment risk.

This leads inevitably to a familiar conundrum: lease finance is generally more favorable from the sell-side perspective in its tax, income statement and balance sheet implications, but senior debt is perceived by the buy-side to be less risky for financiers and is priced at a lower cost of capital.

On the sell side, precise criteria defined by tax authorities and accounting regulators determine for tax and financial accounting purposes respectively whether corporations lease or own assets. On the buy side, fixed-income investment risk analysis is a formal process with uniform procedures and risk classifications to distinguish between the riskiness of lease finance and debt finance and to price any material difference.

Interestingly, each set of criteria to distinguish between forms of fixed-income finance differs slightly from the others. This is not due to regulatory inefficiency, but instead is an inevitable consequence of criteria designed to protect different economic constituencies.¹ Accordingly, the sets of criteria are formulated in response to different economic perspectives.

This suggests that differences between the buy-side and sell-side criteria can be expected in an efficiently functioning regulatory environment.² In particular, opportunities for off-balance-sheet finance are unlikely to disappear in a tidal wave of financial accounting reform.

Accordingly, a new conceptual strategy for at least partial resolution of the lease-versus-buy conundrum is available in principle: designer lease-based products financially engineered to qualify

under one or two sets of criteria as debt finance and to qualify under the remaining criteria as lease finance. Implementation of this strategy could provide corporate financiers with an improved generation of fixed-income financing products, although to date Wall Street has made little effort to explore this possibility.³

An initial breakthrough in implementing the strategy occurred in the late 1980s. A Texas financial boutique discovered that mortgage debt used to finance asset acquisitions could be redesigned to change the debt into leases from the financial accounting perspective. The resulting fixed-income product, known as the synthetic lease, occupies an active niche in corporate finance.

The second breakthrough occurred in the 1990s. The author discovered ABBE® finance, which transforms lease finance into debt from the investment analysis perspective.⁴

Conceptually, ABBE finance is nearly the reverse process of synthetic lease finance. Whereas synthetic lease finance transforms a mortgage debt obligation into a lease from the (sell-side) financial accounting perspective, ABBE finance transforms a lease into a debt-equivalent lessee obligation from the (buy-side) investment analysis perspective.

The resulting fixed-income obligation has investment risk characteristics comparable or superior to senior unsecured lessee debt. The product, known as the ABBE Security, is a particularly pure example of *synthetic debt* because it remains a lease from both sell-side perspectives.⁵

The distinguishing features of the synthetic debt relative to conventional debt are: (1) the synthetic debt represents a fixed-rate off-balance-sheet fixed-income obligation with the same default risk as on-balance-sheet debt, and (2) in default the synthetic debt provides the financier with immediate recourse against the obligor comparable or superior in recovery protection to conventional senior debt.

Synthetic leases and ABBE finance were not developed to illustrate a general strategy in financial engineering, but rather to realize specific objectives - sell-side in the case of synthetic leases and buy-side in the case of the synthetic debt. Accordingly, each asset has some investment and financial characteristics that exist by design and some that exist as an incidental result of the financial engineering.

SYNTHETIC LEASES

Synthetic leases were developed to keep finance of asset acquisitions off the corporate balance sheet while preserving a user-based cost of fixed-income finance. Accordingly, financial engineers approached synthetic lease design as a problem in how to move corporate debt off the corporate balance sheet.

The first part of the solution was to create a special purpose entity (SPE) to hold formal title to the asset, together with a bondable net lease (the synthetic lease) between the SPE and the asset user to

give the lessee operational control of the asset.

The lease contains an option for the lessee to purchase the asset when the lease term expires. In the case of real estate, the option strike price usually equals the original price paid by the SPE for the asset.

An upside covenant unique to synthetic leases transfers ownership rights to the capital gain resulting from any increase in property value during the synthetic lease term from the SPE to the lessee. A unique corresponding downside covenant requires the lessee to reimburse the SPE when the property is sold for nearly any loss due to property value decline during the synthetic lease term.

The upside and downside covenants are not precisely symmetric. While the lessee owns all upside investment risk, the lessee is only responsible for most of the downside investment risk.

The reason for the asymmetry is the design constraint that the asset financing not appear on the lessee balance sheet. In order to permit the lessee to treat the synthetic lease as a conventional lease for financial accounting purposes, the Financial Accounting Standards Board (FASB) insists that the lessee cannot own both all upside property investment risk and all downside property investment risk.

In practice, the risk of a property value decline not covered by the lessee reimbursement covenant is small. The property would have to lose more than 85% of its original value during the synthetic lease term before SPE financiers would be exposed to any economic loss. However, the possibility of such a loss does exist as an incidental result of the design objective that the SPE not appear on the lessee balance sheet.

The most likely outcome SPE financiers can expect at the end of the synthetic lease term is to recover their original investment capital, neither more nor less (due to the upside and downside lease covenants). The most likely event that could derail this outcome is a lessee default. However, due to the cap in the downside reimbursement covenant, SPE financiers have slightly weaker default recovery protection than the protection available to mortgage financiers from on-balance-sheet debt in a conventional asset acquisition.

It follows that capital invested in the SPE has the investment characteristics of fixed-income, with the same default risk as lessee general obligation debt. In other words, SPE investment capital becomes de facto lessee debt that does not appear on the lessee balance sheet. Accordingly, synthetic lease designers have accomplished their objective, modulo the following incidental consequences.

To begin with, tax accounting requirements for lessee off-balance-sheet treatment of SPE investment capital are more stringent than financial accounting requirements. Consequently, it would be imprudent for the lessee to assume without additional supporting evidence that net rental payments can be treated as rent for tax accounting purposes rather than as debt service. In other words, the lessee would be prudent to separate net rent into interest and amortization portions for tax

accounting purposes and expense only the interest portion.

It is also possible that the Internal Revenue Service (IRS) could view the synthetic lease for tax purposes as an actual lease. In this case, tax treatment of the net rental payments would be more favorable for the lessee, since all rent would be expensed by the lessee for tax accounting purposes rather than simply the interest portion. On the other hand, less favorable tax treatment for SPE financiers also would follow, since all net rent would be taxable income for the financiers rather than simply the interest portion.

Thus a tax ambiguity exists as an incidental result of synthetic lease design: favorable lessee tax accounting and unfavorable SPE investor tax accounting, or unfavorable lessee tax accounting and favorable SPE investor tax accounting?

Two obvious approaches exist to resolve the conundrum: request the IRS to issue a letter ruling on which tax interpretation to follow; or lower the net rent to reduce the amortization portion to zero, thereby eliminating the nondeductible debt service portion that constitutes the source of the ambiguity.⁶

Thus far, synthetic lease vendors seem to prefer the second alternative. Consequently, *the first incidental consequence of synthetic lease design is that synthetic lease financings are invariably interest-only, i.e., bullet financings.*

Although property value declines not fully covered by the synthetic lease reimbursement covenant are less likely than lessee default, not all investors appear to view the incremental risk with the same equanimity. In practice, commercial banks appear more comfortable than insurance companies with providing investment capital for synthetic lease SPEs.

However, even banks apparently are not as comfortable with synthetic lease finance as with conventional mortgage debt, because banks extract an additional lessee concession. In order to reduce bank portfolio risk resulting from unequal durations of assets and liabilities, banks prefer fixed-income investments to be floating-rate rather than fixed-rate, and insist on floating-rate financings in the case of synthetic lease SPEs. Accordingly, *the second incidental consequence of synthetic lease design is that synthetic lease financings are floating-rate obligations.*

For financial purposes, U.S. corporations prefer to control their cost of capital. Although corporations frequently borrow at floating rates, the debt covenants usually include options to retire the debt on relatively short notice in order to reduce the risk that rising interest rates can unexpectedly increase the corporate cost of capital for prolonged periods. Consequently, *the third incidental consequence of synthetic lease design is that most synthetic leases are relatively short-term financings, e.g., three to seven years.*

The practical constraints on synthetic leases imply the existence of deficiencies in the product that synthetic lease vendors typically do not disclose.

Problematic Refinancings

The FASB sets requirements on SPE equity capital that must be at risk if the lessee is to avoid being required by FASB to consolidate the lessee and SPE balance sheets for financial disclosure purposes. The required minimum equity has been 3% of total SPE capital since synthetic leases were developed. In real-world finance, the required minimum equity equals the total amount of equity invested in synthetic lease SPEs.⁷

The capital structure of the synthetic lease SPE at the beginning of the initial lease term invariably is a mixture of equity and mortgage debt, which implies that 97% of the SPE investment capital consists of mortgage debt. As discussed, mortgage debt service consists entirely of mortgage interest, and the mortgage term coincides with the initial lease term.⁸ It follows that the entire mortgage principal is due at the end of the initial lease term.

Synthetic leases typically include at least one renewal option. However, any extension of the lease term requires the existence of the SPE through the extended term. Accordingly, each renewal option includes a contingency requirement: the SPE must succeed in refinancing the mortgage debt in order for the option to be exercisable.

If the appraised asset value declines by more than the book value of SPE equity during the initial lease term, then refinance of the original mortgage with new debt requires a financier to loan more mortgage capital to the SPE than the estimated collateral value. In the absence of recourse to other SPE or lessee assets, it follows that replacement debt finance in this case is virtually impossible. Accordingly, the SPE must refinance the original mortgage with a mixture of new mortgage debt and additional equity capital.

As discussed, each class of SPE capital is a fixed-income asset. The primary difference between SPE debt and equity capital is that the equity capital is subordinate to the debt capital for recourse purposes in lessee default. This suggests that any new SPE equity is equivalent for investment analysis purposes to subordinated lessee debt with a contingent liquidation claim on any future appreciation of the SPE asset up to the original acquisition cost but with essentially no claim against any other assets in lessee bankruptcy.⁹

It follows that incremental SPE equity is a riskier commitment than the original equity investment. Accordingly, financiers are unlikely to view incremental SPE equity as an acceptable investment risk unless accompanied by an extremely high dividend yield. Although the advertised benefit of the synthetic lease is off-balance-sheet finance at the cost of senior debt, *it is extremely improbable that the SPE mortgage can be refinanced at the cost of senior lessee debt if the appraised asset value declines by more than the book value of SPE equity during the initial lease term.*¹⁰

In the case of corporate build-to-suits, synthetic leases frequently package the real property together with all equipment and furniture to be housed within the property during the synthetic lease term. In such cases, the synthetic lease provides off-balance-sheet financing for the entire cost of initiating

business operations in the facility from construction planning through occupancy. The drawback of this arrangement is that it is virtually certain at the outset that the value of the equipment and furniture will decline during the initial lease term by much more than 3% of the originally financed amount. Accordingly, unless the real property appreciates enough to compensate for nearly all loss in the value of the equipment and furniture, it is virtually certain that the off-balance-sheet financing will not be renewable at the end of the initial lease term.

Depreciation Problems

The federal tax code includes two separate annual depreciation provisions for the owner of any asset that is depreciable for tax accounting purposes: bestowal of a potential current income tax deduction up to a specified limit, with the additional right to warehouse any currently unusable portion of the deduction until it can be taken; and an automatic reduction in the tax basis of the asset by the available deduction.¹¹

The two depreciation provisions are functionally independent for tax accounting purposes. In particular, any failure by the owner to take advantage of the available deduction does not alter the required tax basis reduction. It follows that the asset tax basis is lower than the asset acquisition cost at asset divestiture. More precisely, the difference equals the cumulative available depreciation deduction during the synthetic lease term (including any renewal terms). Thus the tax accounting capital gain (or loss) generated by asset divestiture exceeds the difference between net sale price and acquisition cost by the cumulative available depreciation during the synthetic lease term.

Assume for the moment that the lessee is the asset owner for tax purposes and that the net sale price at asset divestiture equals the acquisition cost. Then the lessee has a capital gain for tax purposes that equals the cumulative available depreciation during the synthetic lease term, regardless of whether or not the lessee has taken annual depreciation deductions during the synthetic lease term.

Of particular interest is the case in which the net asset value at the end of the initial synthetic lease term has declined by more than the book value of SPE equity but is still greater than the asset tax basis. Then, as discussed, the synthetic lease cannot be renewed and the synthetic lease requires the SPE to divest the asset. If the lessee does not exercise the asset purchase option in the synthetic lease, then the asset must be sold on the open market. In this scenario, *the lessee owes both the SPE and the IRS after the asset is sold*: the SPE must be reimbursed for the actual net loss (the difference between acquisition cost and net sale price) realized at divestiture, and capital gain tax is due on the difference between the net sale price and the asset tax basis.

The lessee can avoid the tax outlay by exercising the asset purchase option in the synthetic lease.¹² The financial accounting interpretation of this scenario is that the lessee is purchasing the asset at an above-market price. By avoiding any SPE reimbursement for the loss in asset market value, the lessee also avoids expensing any reduction in asset value as long as the lessee retains the asset. However, in this event the asset materializes onto the lessee's balance sheet and remains there as a nonearning asset, which negates the original objective of the synthetic lease transaction.

SYNTHETIC DEBT

In contrast to synthetic leases, the ABBE finance version of synthetic debt was developed to solve a buy-side problem. More precisely, the synthetic debt was developed to generate more leverage for real estate investors from credit-based finance of single-tenant property. Since the amount of leverage varies inversely with the cost of finance, generating more leverage is equivalent to lowering the cost of finance. Thus the design problem is equivalent to reducing the cost of lease-based finance below conventional fixed-income alternatives.

The lowest-cost fixed-income finance for single-tenant property usually results from a bondable mortgage, *i.e.*, a mortgage that insurance industry regulations permit insurance companies to classify as lessee debt for investment purposes. This requires a bondable net lease, *i.e.*, a lease in which the lessee assumes responsibility for and control over all property-related expenses and obligations during the lease term. The bondable mortgage finances the present value of the lease rather than the property market value. Accordingly, lessee credit rating determines the cost of bondable mortgage debt.

The cost of bondable mortgage debt is closely related to the lessee cost of debt. However, the cost of bondable mortgage debt is usually slightly higher than the lessee cost of debt. The mortgage financier can usually be expected to charge an additional risk premium because mortgage default recourse is directed inefficiently against the property owner rather than the lessee.

The mortgage financier does have indirect default recourse against the lessee if lease default triggers a corresponding owner default on the mortgage. However, mortgage financier access to the legal mechanisms of lease default recourse can only be realized after successful conclusion of a foreclosure proceeding on the property. Accordingly, financier access to the default recourse mechanisms likely will arrive too late for the financier to participate in debt and lease restructuring negotiations with the lessee. It follows that mortgage financier loss protection is inefficient in lessee default, which implies an incremental risk premium relative to lessee debt.

The problem of lowering the cost of lease finance can be reduced to the problem of eliminating the incremental risk premium from bondable mortgage debt. A conceptual solution to this problem would be to remove the property owner as an obstacle between the financier and access to lease default recourse.

It turns out that property law contains features predating the Constitution that allow the removal to be implemented very neatly. Archaic features of property law applied occasionally in personal estate planning but underutilized by the corporate sector allow ownership of the property to be split temporally into barely related ownership interests: (1) a term interest that represents ownership of the property during the initial lease term, and (2) a remainder interest that represents ownership of the property after the initial lease term expires.

Instead of creating a mortgage on the entire property, the lease financier purchases ownership of the term interest. The property investor purchases the remainder interest. Each investor pays part of the property acquisition cost, as in conventional acquisitions in which owner leverage is provided by mortgage finance.

From an investment analysis perspective, the lease financier purchases the right to receive all net rent from the lease during the initial lease term together with a security interest in the lessee property rights. The purchase price paid by the financier is leverage from the perspective of the property investor, who essentially purchases the rights to unencumbered property ownership after the initial lease term. Conceptually, the property investor forgoes the right to receive net rent during the initial lease term in return for a lower purchase price than the cost of an unleveraged purchase.

Real estate term interest ownership is a real property investment. However, ownership of the term interest looks like ownership of lessee debt from an investment analysis perspective. Since the bondable net lease transfers all property-related risk to the lessee, the term interest owner is a passive investor whose only concern is recording scheduled net rental payments provided the lessee performs with respect to the lease.

The term interest owner has immediate and complete discretionary control over enforcement of lease default recourse provisions. Accordingly, term/remainder separation removes the obstacle between the financier and control of lease default recourse. Prompt access to and control of lease default recourse implies strengthened loss protection in default for the term interest investor/financier relative to conventional mortgage finance.

Lessee-lessor negotiations take precedence over debtor-lender negotiations in bankruptcy proceedings. It follows that default recourse for the term interest investor also compares favorably to default recourse for investors in conventional on-balance-sheet debt. Thus, subject in the case of each lessee to the mix of leases and general obligation debt outstanding, the cost of synthetic corporate debt can be expected to compare well with the cost of on-balance-sheet debt.

It follows that synthetic debt finance is the reverse of synthetic lease finance in one additional way. Whereas *synthetic lease finance weakens default recourse* available to the financier when mortgage debt is moved off the lessee balance sheet, *synthetic debt finance strengthens default recourse* available to the financier when lease finance is converted to synthetic debt.

As already discussed, synthetic debt was developed to benefit buy-side investors by increasing the leverage available from credit-based lease finance without impacting the lessee. In fact, term/remainder separation can be implemented at any time during the term of a bondable net lease without any need for the lessee to become aware that an additional investment structure has been layered between the lessee and the buy-side investors. Thus *the significant sell-side consequence of synthetic debt design is that lessee tax and financial accounting perspectives are unchanged by term/remainder separation*. In particular, financial accounting criteria for off-balance-sheet lease accounting are unaffected by term/remainder separation.

Since term/remainder separation is invisible from the sell-side perspective, the operative sell-side question is how term/remainder separation can benefit the balance sheet or income statement of the corporate lessee.

First and foremost, the above observations imply that the corporate lessee can only benefit from term/remainder separation through involvement in implementation of the separation. This can occur in two ways: by negotiating economic concessions in the lease that are not necessarily feasible in the absence of term/remainder separation, and by making an investment in the remainder interest.

For example, any enhancement of leverage through creation of synthetic debt translates into a smaller capital investment by the property investor than would result from conventional leverage. It follows that option rents during lease option terms can be lower than in the case of conventional leverage and still generate the property investor's required rate of return.

Tax and financial accounting considerations are paramount in the structuring of benefits for the corporate lessee. As a rule of thumb, regulations that determine lessee tax and financial accounting implications of lease renewal provisions and remainder investment interests look through the term/remainder separation structure. This simplifies design of financial strategies and selection among possible alternatives. However, professional opinions specific to each case from qualified tax counsel and financial accountants are essential prior to actual implementation.

This is the conceptual story of lease-based synthetic debt. If it were the entire story, clever corporate lawyers and investment bankers probably would have discovered this form of synthetic debt long ago. However, a number of nagging technical buy-side issues needed to be resolved. Foremost among these is that, in order to constitute low-risk investments, the term and remainder interests need additional structure to preserve the assets and protect their investment characteristics. This is achieved by creating one or more SPEs to hold legal title to the term and remainder interests.

In practice, the SPEs are usually grantor trusts. The SPEs impact risk analysis only from the buy-side perspective. The SPEs are invisible from sell-side tax and financial accounting perspectives.

Accordingly, the financier and property investor purchase beneficial ownership of the term and remainder interests respectively instead of legal title to the interests. Beneficial ownership of the term interest is known as the ABBE interest, and beneficial ownership of the remainder interest is known as the LURE® interest.¹³ The ABBE interest is a ratable fixed-income investment with a credit rating determined by lessee creditworthiness.

For more information on the ABBE/LURE structure and the buy-side perspective on synthetic debt, see Graff (1999). For more information on synthetic debt finance from the sell-side perspective and the comparison with synthetic lease finance, see Graff (2001).

The financial fine-tuning that creates the ABBE/LURE structure and enables the structure to be applied to corporate finance is a recent innovation. Key portions of the structure involve technology patented by Graff/Ross Holdings and licensed exclusively to Electrum Partners LLC.¹⁴

CONCLUSION

Off-balance-sheet corporate obligations can arise in efficiently regulated financial markets in which separate buy-side and sell-side regulators have mandates to protect different market constituencies. In the case of lease-based finance, two off-balance-sheet fixed-income products have developed within the past 15 years: synthetic leases and synthetic debt.

Both products can be employed to finance corporate acquisitions of tangible assets. However, the products result from essentially opposite processes. Synthetic lease finance utilizes leases of unique design to move mortgage debt off the corporate balance sheet from the (sell-side) financial accounting perspective. By contrast, synthetic debt finance imposes unique legal structure between lessees and capital sources to transform leases into senior debt-equivalent obligations from the (buy-side) investment analysis perspective.

In the case of synthetic lease finance, tax law is ambiguous on the identity of the asset owner for tax accounting purposes. Consequently, synthetic leases are interest-only financings in order to avoid any lessee uncertainty about rent deductibility for tax purposes. Synthetic leases generate floating-rate debt rather than fixed-rate debt because institutions in the fixed-rate debt market typically decline to finance the debt. Synthetic lease renewal options contain contingencies because the off-balance-sheet debt is virtually impossible to refinance if the asset value declines by more than the book value of SPE equity.

Due to the tax accounting ambiguity regarding asset ownership, synthetic lessees frequently decline to utilize depreciation tax deductions generated by the tangible assets. However, the tax code stipulates that available depreciation tax deductions reduce owner tax bases in depreciable assets, regardless of whether or not the deductions are taken. It follows that capital gains accrue from the mere availability of depreciation deductions and that the capital gains become taxable income at asset divestiture.

Depreciation merely defers income in tax and financial accounting. It follows that greater tax depreciation than financial accounting depreciation implies more taxable capital gain than financial accounting capital gain at asset divestiture. Accordingly, asset owners in synthetic lease financings owe capital gain taxes at asset divestiture unless asset values decline during the synthetic lease terms by more than the available depreciation.

In the case of synthetic debt finance, single-tenant property ownership is separated temporally into term and remainder interests for the duration of the primary lease term. With additional financial engineering, the term interest becomes a ratable fixed-income security with default recourse at least comparable to the default recourse of senior lessee debt.

Purchase of the term interest by fixed-income investors can be viewed as leverage that enables the remainder interest investors to acquire the asset for a fraction of its value by forgoing the rights to

any income from the asset during the primary lease term. However, both the term interest and the remainder interest are debt-free equity interests in the asset. Lease-based synthetic debt finance produces an all-equity asset ownership structure.

The term and remainder interests have very different investment characteristics that are essentially independent from both economic and legal perspectives. Accordingly, the lessee in a synthetic debt financing can invest in the economic future of the leased asset by purchasing an equity position in the remainder interest without affecting the investment characteristics of the term interest or the risk exposure of the term interest investors.

Lessee investments in remainder interests are on-balance-sheet investments. However, the investments can be expected to perform as earning assets on lessee balance sheets, since remainder interests expand toward full and unencumbered ownership of the tangible assets as the term interests amortize toward zero. Accordingly, the primary motivation for keeping equity investments in tangible assets off corporate balance sheets disappears if the assets are financed with lease-based synthetic debt.

The exhibit summarizes the notable features of the two off-balance-sheet lease-based financial technologies.

Exhibit: Comparison of Synthetic Lease Finance And Synthetic Debt Finance

	Synthetic Lease	Synthetic Debt
Off-Balance-Sheet Finance	Yes	Yes
Cost of Finance	Lessee Cost of Debt	Lessee Cost of Debt
Amortization of Principal	No	Yes
100% Finance	Yes	No
Buy-Side Perspective	Floating-Rate Lessee Debt	Fixed-Rate Lessee Debt
Financial Accounting Perspective	Lease	Lease
Tax Accounting Perspective	Floating-Rate Lessee Debt	Lease
Renewable Financing	Indeterminate	Yes

NOTES

1. The U.S. financial accounting regulators are the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB). The missions of the SEC and FASB encompass broad protection of investors in the corporate security markets. In the case of corporate debt, financial accounting regulation can be oriented primarily toward sell-side regulation (protecting investors in corporate equity) or buy-side regulation (protecting investors in corporate debt). Both regulators proposed new accounting standards for debt following the appearance earlier this year of price instabilities in stocks of various publicly traded corporations in apparent response to the corporate utilization of off-balance-sheet debt. However, the regulators were aware several years earlier from synthetic lease sales literature that corporate borrowers were abusing fixed-income investors by using off-balance-sheet debt to circumvent debt restrictions in corporate bond covenants. This suggests that the primary mission of the regulators is sell-side regulation.
2. This situation can only be avoided by requiring a single set of criteria for the lease-versus-debt determination. The resulting criteria would represent a compromise from either the sell-side or buy-side perspective. This suggests that the elimination of off-balance-sheet fixed-income finance would necessitate the sacrifice of efficient fixed-income market regulation.
3. Although investment banks have not created corporate finance applications based on multiple boundary criteria in the debt-vs-lease dichotomy, the banks have created corporate finance applications based on multiple boundary criteria between other security classifications. For example, in 1993 Goldman Sachs created Monthly Income Preferred Securities (MIPS) to exploit an on-balance-sheet dichotomy in the case of the debt-vs-equity classification. In this case, the relevant dichotomy occurs in the security classifications for tax accounting and financial accounting purposes, *e.g.*, see McKinnon and Hitt (2002).
4. ABBE is a registered trademark of Graff/Ross Holdings.
5. In the securities industry, the expression *synthetic debt* is utilized in an inclusive sense to signify any securitized financial obligation that has tax or investment characteristics identifiable as substantially equivalent to some particular type of debt of an identifiable obligor, but that was not issued as that type of debt by the obligor and is not so classified for financial accounting purposes on the obligor's balance sheet. The definition of synthetic debt employed in this study is much more restrictive.
6. The IRS stringently has avoided taking an official position on the identity of the asset owner in the synthetic lease structure for tax purposes. An indication of official thinking on this question is contained in Internal Revenue Service National Office Field Service Advice 199920003. The advisory, issued in response to queries from IRS field service representatives, directs them to

consider the lessee as the asset owner, see Butler (1999). However, the advisory begins with the disclaimer that: "Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent." The conclusion of the advisory includes the additional caveat that: "We find this a difficult and close call...".

7. As part of a comprehensive response to the widening accounting scandal triggered by the Enron Corporation collapse, FASB has announced a proposal to revise the required minimum amount of outside equity capital for the synthetic lease SPE upward to at least 10%. The proposed revision also prohibits any lease reimbursement covenant to shield against SPE investment loss, as well as any lease purchase option for the asset that specifies a fixed price. If implemented as proposed, the new standard will apply immediately to synthetic leases created after July 2002, and to existing synthetic leases starting in the lessee's first fiscal year beginning after mid-December 2002.
8. For more detailed analysis, see Graff (2001).
9. This is the conservative/worst interpretation from the SPE equity investor perspective. Synthetic lease default has not yet been tested in bankruptcy court.
10. Essentially the same reasoning shows that the synthetic lease almost certainly is not renewable at the end of any lease option term in which the appraised asset value at the end of the option term has declined from the original acquisition cost by more than the book value of the SPE equity.
11. The tax basis of an asset is an adjusted acquisition cost used in determining any capital gain or loss for tax purposes when the asset is divested. The tax basis adjustment provision implies that annual depreciation deductions generate tax deferrals, not tax avoidance. More precisely, annual reduction in the asset tax basis by an amount equal to the available depreciation deduction links any current available tax reduction to a corresponding future increase in the capital gain tax that accrues at asset divestiture. Depreciation merely aligns the timing of tax payments more equitably with the timing of the expected economic benefits of asset ownership.
12. Under the assumption that the lessee already owns the asset for tax accounting purposes, exercise of the purchase option is not a taxable transaction. The purchase is interpreted from the tax perspective as the retirement of an asset financing.
13. LURE is a registered trademark of Graff/Ross Holdings.
14. The author is a cofounder and principal of Graff/Ross Holdings and Electrum Partners, and holds investment interests in both entities.

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