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A Brief History of Synthetic Leases

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A synthetic lease is a credit-based finance structure that achieves operating lease treatment for accounting purposes but is treated like ownership for tax. Synthetic leases first became popular in the early 1990's. At the time these "off balance sheet" obligations required a minimum of 3% at-risk lessor equity provided by a party unrelated to the lessee. These rules governed all operating leases and many other non-real estate transactions designed as off-balance sheet structures. Entities in the form of SPEs, SPVs or Beneficial Trusts were created for the sole purpose of acting as lessor in a synthetic lease.

Then came Enron. Enron violated the 3% third-party equity requirement by using an affiliated entity to fund the equity. This is a primary factor that led to the demise of Enron and its auditor, Arthur Anderson. Few new synthetic leases occurred in the years immediately following Enron as no executive wanted to promote anything called "an off-balance sheet structure," regardless of the potential benefits.

FASB, with urging from the SEC and others, began focusing on issues that would define the circumstances under which a lessor would consolidate onto the balance sheet of the lessee. This issue had troubled FASB since the original FAS 13 was written in the 1970's and Enron, WorldCom, and others forced them to act. FASB's solution was called Fin46(R). Fin 46(R), now codified as part of ASC 810, addresses consolidation of variable interest entities as an interpretation of Accounting Research Bulletin (ARB) No. 51.

For synthetic leases this meant that lessors could no longer be SPEs, SPVs or Trusts created solely for the purpose of being a lessor in the transaction. Instead, the lessor in a synthetic lease must be a "substantive entity," with the practical meaning that they are lessors with at-risk equity in numerous transactions. The result is that lessors today are primarily equipment lease finance groups at major global banks that participate as lessors in aircraft, railcar, shipping, real estate, and many other forms of lease financing. This accounting guidance created a narrow range within which a synthetic lease could be structured while at the same time offering safe harbor if the rules are followed. Synthetic leases again became popular choices for core real estate assets.

ASC 842 has dramatically increased interest and use of synthetic leases by corporate occupiers. The new lease accounting standard requires capitalization of the PV of rent plus any contingent liability if a loss is expected. At the expiration of the synthetic lease a lessee has three basic options: 1) purchase the property (for the outstanding principal amount), 2) negotiate a renewal of the synthetic lease (by rolling over the principal amount), or 3) terminate the synthetic lease and sell the property. It is only if the property is vacated and sold that a loss is likely. A synthetic lease wouldn't be used if an end-of-term vacancy and sale is likely. For this reason only rent expense is typically capitalized as the ROUA and liability, not the underlying principal balance.

Under ASC 842 the synthetic lease offers the lowest cash rent, reported rent, and smallest balance sheet impact compared to any other form of lease or financing for ownership. As a result, there is a strong increase in interest and use of synthetic lease financing for build-to-suits or acquisitions of core properties by corporations across a wide range of industries.

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