

**Deloitte.**

**Real estate rationalization:  
Accounting, valuation, and  
income tax considerations**

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# Setting the stage

# Background

Companies in almost every industry and sector continue to reevaluate how they are doing business as well as the impact of their ever-evolving business strategies on their brick-and-mortar real estate needs. In addition, such companies continue to consider where their employees conduct their required business activities and to what extent brick-and-mortar real estate assets will be needed for such activities on a go-forward basis. That is, some continue to refine their

hybrid-work approaches. While vacancy rates for office properties in certain areas may have been higher a couple of years ago because more professionals were allowed to spend a greater percentage of their time working from home, many entities are now expecting their employees to work more days in the office, emphasizing the importance of collaboration, sense of community, and professional development.

Because of these strategic shifts, many companies continue to undertake real estate rationalization programs to determine their appropriate organization-wide real estate footprint. The goal of initiating these types of programs is to rightsize their real estate portfolios to manage costs while supporting their overall business needs.



# New, remeasured, and amended leases and impairment/abandonment

As a result, companies continue to reassess their real estate footprint and adjust their real estate portfolios. Some have made the decision to relocate to different-size spaces in the same geographical area, while others are changing the amount of space they are leasing in their current location. These decisions often have a direct impact on a company's real estate lease portfolio. For example, some may execute lease agreements for new space or modify existing arrangements for leases that are already in place. In addition, some companies may find it advantageous to execute options in their existing lease agreements, such as renewal, termination, or purchase options. Certain of these decisions may also have additional consequences such as the need to evaluate whether the related leased assets should be assessed for impairment or abandonment accounting. Additionally, the accounting, valuation, and income tax considerations are often complex and not straightforward.

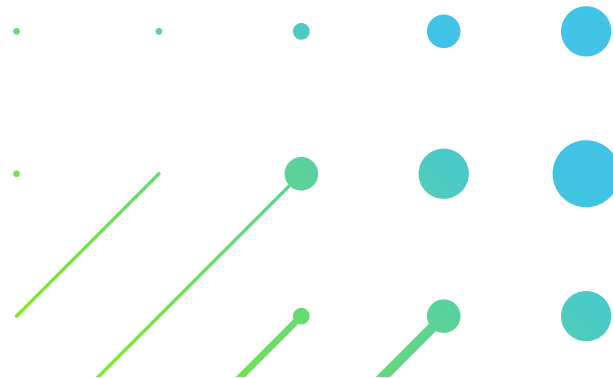
## Did you know...

Lease right-of-use (ROU) assets are generally not assessed for impairment in a vacuum. Rather, ROU assets, including those related to real estate leases, are subject to the ASC 360 impairment requirements, which are applied at the asset group level. While the decision to vacate a property may be an impairment indicator under ASC 360, the impairment recoverability test is performed at the asset group level, which would take into account the cash flows for all of the assets in the asset group. Properties subject to a lease that do not have separately identifiable cash inflows and outflows would most likely need to be evaluated at a level higher than the level of the individual ROU asset. For example, if an entity starts scaling back the use of its corporate headquarters, an impairment indicator for the asset group may exist because “[a] significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used” may have occurred in accordance with ASC 360-10-35-21(b). However, the undiscounted cash flows of the entire asset group would be used for the recoverability test; as a result, the entity may conclude that the asset group (and thereby the ROU asset associated with the corporate headquarters) is not impaired even though the use of the corporate headquarters has been scaled back.

# Build-to-suit, synthetic leases, and sale-and-leaseback arrangements

As an observation, the frequency of certain unique lease-related and lease-adjacent transactions have increased significantly. This includes (1) build-to-suit arrangements for a customized property build-out, (2) synthetic leases that include unique provisions and end-of-term conditions that need to be assessed, and (3) traditional or synthetic sale-and-leaseback transactions that will likely require a comprehensive assessment. The terms in these types of arrangements matter as certain terms could result in the would-be lessee being the deemed accounting owner of the property and the recognition of a financial liability (debt) on its balance sheet. For example, in a build-to-suit arrangement, an evaluation would be needed to determine whether the lessee controls (i.e., owns the property for accounting purposes) the property that is being constructed per the accounting rules.

If the property is deemed in control of the lessee during the construction period, then the transaction will be subject to the sale-and-leaseback rules to see if the property can ultimately be derecognized at the lease commencement date or if it will be considered a failed sale and subject to a financing arrangement. Build-to-suit arrangements, synthetic leases, and sale-and-leaseback transactions are often highly complex with the terms and conditions of the agreement potentially having a significant impact from an accounting and income tax perspective. Understanding the valuation considerations are similarly critical to properly accounting for these types of arrangements.



## Did you know...

When executing a sale-and-leaseback transaction, upon the completion of a project in which the lessee was the deemed accounting owner or in relation to a traditional or synthetic sale-and-leaseback transaction, it is important to understand the impact of certain agreement provisions. For example, if the leaseback of a property includes a repurchase option (regardless if it is at fair value) or if the leaseback is classified as a finance lease, the transaction will not qualify for sale treatment. Therefore, for accounting purposes, the proceeds in the transaction will be recorded by the seller as a financial liability (debt) and the buyer as a financial asset (receivable), with the property remaining on the seller's balance sheet as an "owned asset" for accounting purposes. Often times, this is not the desired outcome by either party.

# Business combination and asset acquisition considerations

Some companies are expanding their business through acquisition, which often results in the expansion of their real estate portfolio through the acquisition of additional real estate interests in the form of owned or leased properties through business combinations or asset acquisitions. The relevant US GAAP guidance includes explicit guidance for the accounting for properties subject to a lease in a business combination and there are interpretive views that have evolved on the accounting for a lease in an asset acquisition. Knowing the accounting and income tax rules, the resulting accounting, as well as valuation-related implications, is key to properly accounting for these types of transactions.

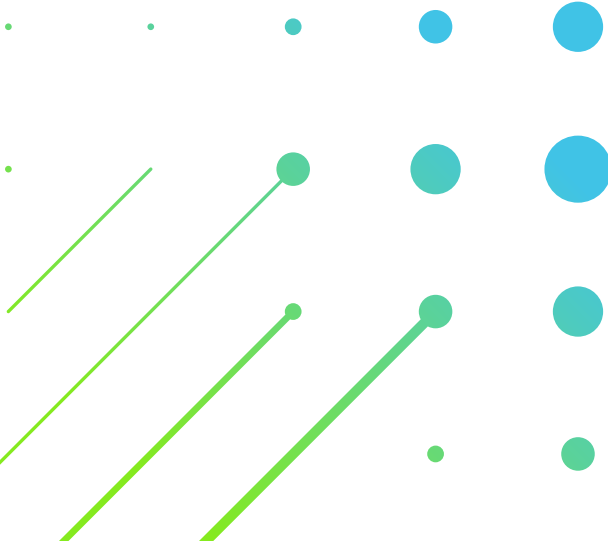
## Did you know...

An acquirer will account for a lease as if it is a “new lease,” assessing whether available options (e.g., renewal, termination, and purchase) are reasonably certain of being exercised at the acquisition date. Irrespective of whether the conclusions about the renewal options will result in the lease term being for a major part of the economic life of the asset or the conclusions about purchase options indicate that the acquirer will ultimately purchase the asset at the end of the lease term, this will have no bearing on the lease classification of the acquired lease. The accounting guidance is clear that an acquirer in a business combination should retain the acquiree’s classification of its leases unless “there is a lease modification and that modification is not accounted for as a separate contract.” As an observation, there have been scenarios where an acquirer has concluded that the lease term or conclusions about options would have otherwise resulted in finance lease classification, but resulted in operating lease classification due to the requirement to carryforward the acquiree classification. The same principle holds true for transactions previously characterized as a financing arrangement due to a former sale-leaseback not achieving “sale” treatment. The acquirer should continue to use the acquiree’s accounting for the failed sale-and-leaseback transaction until the transaction meets the requirements in ASC 842-40 and ASC 606 for the transfer to be accounted for as a sale. The assets and liabilities related to the arrangement should be measured at their acquisition-date fair values.



# Other lease-related considerations

Some companies have started changing systems and processes to adapt to their evolving real estate portfolio. In this respect, we have observed certain companies migrate from one existing lease accounting technology solution to another, implement new lease accounting technology where a legacy system did not exist, or refine the attributes for an existing technology with each of the actions designed to adapt to the changing portfolio. In addition, some companies have made the strategic decision to outsource the lease accounting and operations functions to a third party to allow for more efficiency and cost savings.





# Navigating the path forward



Terms and conditions of an agreement matter! Equally as important, considering the accounting rules, knowing where a valuation specialist might need to weigh in, and understanding the income tax implications are paramount because the terms and conditions of an agreement when considering these factors will likely have a direct impact on how the transactions are accounted for in your financial statements and from an income tax perspective.

You don't need to go it alone. Deloitte has experienced accounting, valuation, and income tax professionals who can provide advice and recommendations when navigating these types of transactions. This includes helping analyze, document, model, and provide valuation as well as income tax knowledge in various areas that include, but are not limited to, the following:

**Lease transaction evaluation guidance for new, remeasured, or modified leases**

Accounting position memos, model build-out, lease abstraction

**Valuation advice for real estate rationalization initiatives**

Impairment, remaining economic life, asset fair value

**Discount rate calculation**

Rate implicit in the lease, incremental borrowing rate, risk-free rate, market adjusted rate

**Lease transaction modeling**

Build-to-suit, sale-leaseback, synthetic leases, business combinations and asset acquisitions

**Lease-related transaction income tax implication evaluation**

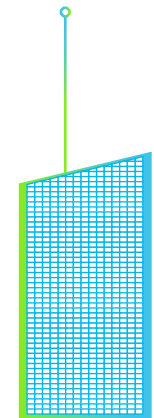
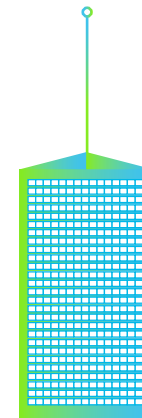
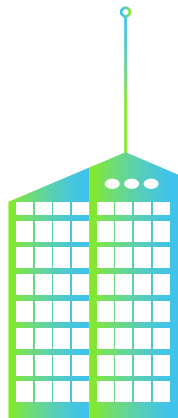
Build-to-suit, sale-leaseback, synthetic leases, general lease transactions

**Lease accounting technology system migration and/or implementation**

Lease abstraction, data conversion services

**Processes, controls, and operations for lease management-related activities**

Adding and refining processes and controls, outsourcing lease management activities





**Let's talk**



# Let's talk

For additional information regarding the above and other lease-related accounting, valuation, and income tax services that are available, please contact:



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## Additional resources:

[Deloitte Roadmap, Leases](#)

[Deloitte Roadmap, Business Combinations](#)

[Demystifying the leasing standard: How to determine your discount rate for lease measurement](#)

[Real Estate Rationalization 101: Current Market Trends and the Potential Accounting Implications From a Lessee's Perspective](#)

[Deloitte Roadmap, Income Taxes](#)



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