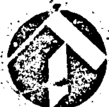

NATIONAL CREDIT UNION ADMINISTRATION

WASHINGTON, D.C. 20456

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OFFICE OF GENERAL COUNSEL

Charles L. Williams, III, Esquire
Blalack & Williams
Attorneys and Counselors
14673 Midway Road, Suite 107
Dallas, TX 75244

Dear Mr. Williams:

This is in response to your letter of June 25, 1985. The issue you present may be broken down into two parts. First, can a Federal credit union (FCU) sell its computer hardware and software to its wholly-owned credit union service organization (CUSO) and finance such a sale? Second, is it permissible for a CUSO to lease the computer hardware and software to the selling credit union and other credit unions?

In answer to the first part, an FCU may sell its computer pursuant to its authority to "purchase, hold, and dispose of property necessary or incidental to its operations." (See Section 107(4) of the FCU Act, 12 U.S.C. §1757(4).) An FCU may finance such a sale. The financing would not be considered a loan to the CUSO, but rather the financing is an installment sale. This type of sale and financing is addressed in Section 5110.1.4 of the Accounting Manual for FCU's (enclosed).

Although installment sales do not constitute loans and are not subject to the lending limitations of the FCU Act (e.g., loans to CUSO's are limited to 1% of paid-in and unimpaired capital and surplus--see Section 107(5)(D) of the FCU Act, 12 U.S.C. §1757(5)(D)), such sales and financings cannot be used as a circumvention of the lending limitations of the FCU Act. We recognize the potential for abuse in this area. Installment sales cannot be used as a method of making loans that would be improper under the FCU Act (e.g., an FCU purchasing an asset with the sole intent of reselling it and financing the resale to a CUSO). FCU's engaging in such activity will be dealt with through NCUA's administrative enforcement process.

In answer to the second part, the CUSO must be in compliance with Section 701.27 of the NCUA Regulations (12 C.F.R. §701.27). The present regulation lists data processing and accounting systems as permissible CUSO activities (see Section 701.27(b)(1)). The

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NCUA Board issued a new proposed CUSO regulation on September 5, 1985. The proposed CUSO regulation specifically lists sale or lease of computer hardware and software as permissible CUSO activities. (See 50 F.R. 36998, 9/11/85). Under the proposal, a CUSO can lease computer hardware and software to credit unions, as long as it is in compliance with the rest of the regulation. We have not resolved the issue of whether the present regulation allows a CUSO to sell and/or lease computer hardware and software to credit unions or if it is limited to the sale and/or lease of software and performance of accounting and data processing services on behalf of credit unions. We consider this a "grey area" activity. This issue will be clarified in a new final rule. In the interim, we have adopted an informal policy that a CUSO involved in such "grey area" activities prior to January 25, 1985, may continue to do so until the issues are clarified in a new final rule. No new "grey area" activities of this kind should be instituted. We anticipate that a new final CUSO rule will be in place by March 1986.

We have not addressed the issue of sale and leaseback in this letter since we have not been presented with sufficient facts to do so. We refer you to NCUA's Interpretive Ruling and Policy Statement 81-7 that addresses sale and leaseback (enclosed) and which would apply to the transaction described in your letter.

We hope that we have been of assistance. If further questions arise, please contact Hattie Ulan of this Office.

Sincerely,

STEVEN R. BISKER
Assistant General Counsel

Enclosures

HMU:cch

- Outstanding loan balance when the obligation was cancelled.

If information about the collateral is expected to be of such a volume that it is not readily adaptable for form FCU 102, a card with this information on it can be attached to form FCU 102.

The lower portion of form FCU 102 can be used to record transaction activity pertaining to the asset, as well as the costs that have been posted to Assets Acquired in Liquidation of Loans (Account No. 708). The beginning balance shown on the form will be the forced sale net realizable value of the asset at the time the loan was cancelled. This value may be obtained from published valuation guides for such items as automobiles, boats, motor homes, and other consumer goods. Thereafter, the worksheet will be recorded with the activity and costs associated with the dissolution of the collateral. Balances should be extended as entries are made on the worksheet. Each entry should be adequately described in the "explanation" column.

By maintaining worksheet records in the manner described above, the credit union will have a working record of all transaction activity, and other pertinent information, relating to the assets the credit union has acquired. The total of the balances shown on these worksheet records must equal the balance of General Ledger Account No. 708 monthly.

5110.1.4 NOTES AND CONTRACTS RECEIVABLE (ACCOUNT NO. 710)

When collateral property is disposed of it is generally favorable if the property is sold for cash. If need be, the credit union may accept a note for all or part of the proceeds of the sale, or it may enter into some other kind of contractual agreement with the purchaser for the payment of the purchase price over a reasonable period of time. The amount due the credit union must be established in Account No. 710, whether the sale is to a member or a nonmember. The details of the note or contract will be described in the General Ledger. If notes or contracts are numerous, subsidiary records must be established for each note or contract to support the General Ledger control account. Interest income on a note or contract receivable will be credited to Miscellaneous Operating Income (Account No. 151).

5110.2 DISPOSITION OF THE PROCEEDS FROM THE LIQUIDATION OF COLLATERAL IN POSSESSION OF THE CREDIT UNION

Following is the order in which the proceeds of the sale of the collateral will be applied. If the credit union is bound to an agreement for application of the proceeds of the collateral, such agreement will take precedence over the order listed below.

If the sale is for cash or under a note or contract, the proceeds will be debited to the appropriate account, and the credits will be applied in the order and to the extent listed below:

(a) To Assets Acquired in Liquidation of Loans (Account No. 708) to the extent that this account has been charged (debited) for costs in connection with the collateral.

(b) To Loans, Collateral in Process of Liquidation (Account No. 707) to the extent of the balance of the loan.

(c) To Allowance for Loan Losses (Account No. 719) to the extent that charge offs have been made in connection with the loan to which the collateral has been related.

(d) To Interest on Loans (Account No. 111) to the extent of any interest due on the loan.

(e) To Miscellaneous Operating Income (Account No. 151) providing the credit union is to retain such gain. However, if the sale is under a note or contract, any gain on the sale will be deferred by crediting the amount of the gain to Deferred Gain on Liquidation of Loans (Account No. 883). This gain will be amortized and absorbed as income over the remaining term of the note or contract.

As shown above, in the absence of a binding agreement or other requirement, statutory or otherwise, the credit union will apply to Miscellaneous Operating Income, Account No. 151, the excess of the proceeds of the sale of the collateral over the amounts that are applied to other accounts. The board of directors should keep in mind that it is not the function of the credit union to earn income in this manner. Consideration should be given to voluntarily returning the excess to the borrower

TITLE 12 - BANKS AND BANKING

CHAPTER VII - NATIONAL CREDIT UNION ADMINISTRATION

[IRPS 81-7]

Interpretive Ruling and Policy Statement

Sale-and-Leaseback Arrangements

AGENCY: National Credit Union Administration (NCUA).

ACTION: Interpretive Ruling and Policy Statement.

SUMMARY: This document defines sale-and-leaseback transactions as falling within the provisions of Section 107(4) of the Federal Credit Union Act (12 U.S.C. 1757(4)) and Section 701.36 of the National Credit Union Administration Rules and Regulations (12 C.F.R. 701.36). It describes conditions which are necessary to constitute a valid sale-and-leaseback arrangement. The document cautions all federally insured credit unions against improperly constructed sale-and-leaseback arrangements that would subject the credit unions and the National Credit Union Share Insurance Fund, to undue risks and losses, resulting therefrom. Implementation of an improperly constructed sale-and-leaseback transaction could cause the National Credit Union Administration Board to take administrative action under the provisions of Section 206(b)(1) of the Federal Credit Union Act (12 U.S.C. 1786(b)(1)) for unsafe and unsound practices.

EFFECTIVE DATE: Upon publication.

ADDRESS: National Credit Union Administration, 1776 G Street, N. W., Washington, D. C. 20456.

FOR FURTHER INFORMATION CONTACT: Harry E. Moore, Accounting Officer, Office of Examination and Insurance, telephone number (202) 357-1065.

SUPPLEMENTARY INFORMATION:

1. Background Information.

In recent years credit unions have experienced a decline in share growth. This decline caused credit unions to seek borrowed capital from outside sources at high interest costs to satisfy members' needs. During the same period, credit unions have had to compete for deposits with other financial institutions by offering high dividend rates. To meet this cost-price squeeze, some federally insured credit unions turned to sale-and-leaseback transactions. Sale-and-leasebacks offered the potential for immediate significant gains that could be used for dividends. Factors disregarded in some cases were: the collectibility of the note offered in payment, the time value of money, the ability to foreclose on the collateral, and the liability incurred as a result of the lease.

Examinations of Federal credit unions and federally insured state-chartered credit unions that have entered into sale-and-leaseback arrangements have disclosed questionable arrangements that have been characterized as sale-and-leaseback transactions. The arrangements are similar in nature in that each involves: a long-term note that has a maturity ranging from approximately 25 to 30 years; a short-term lease ranging in maturity from approximately 1 to 5 years; an interest rate on the note that appears to be significantly below the market interest rates for similar transactions; a borrowing of the downpayment; a downpayment that is significantly below the amount that would be required for the type of financing and property involved; and a senior lien which subjects the seller-lessee to a second lien on the building sold. The National Credit Union Administration has reviewed the economic substance of these transactions and has considered the views of accounting specialists in other federal financial institution regulatory agencies, representatives of the American Institute of Certified Public Accountants, representatives of private industry, as well as published interpretations of sale-and-leaseback transactions from the accounting industry, and recent court decisions. The National Credit Union Administration Board has interpreted these arrangements as being contrary to the definition of a valid sale-and-leaseback arrangement as stated herein. The arrangements have thus been deemed financing transactions rather than sale-and-leaseback transactions. In addition, the resulting gains from some of these transactions were recognized over the periods of the short-term leases, rather than over the amortization schedules of the above-mentioned notes. Thus, due consideration was not given to capitalization techniques and the time value of money in accordance with generally accepted accounting practices. Giving consideration to the latter, some of the recorded gains would actually result in significant losses.

The National Credit Union Administration Board recognizes the benefits of sale-and-leaseback transactions when they are properly arranged and constructed. Sale-and-leaseback arrangements, when properly planned, can provide liquidity by freeing up capital that is concentrated in fixed assets. Sale-and-leaseback arrangements, when properly planned and carried out, can provide the necessary funds to improve the credit union's earnings capabilities during a period of inflationary pressures. The National Credit Union Administration Board wants to emphasize that a sale-and-leaseback arrangement must not be constructed and implemented for the sole purpose of obtaining a one-time significant gain for the purpose of providing immediate earnings for current dividends. Such an arrangement may have a detrimental impact on the long-term operations of the credit union.

In those cases where credit union officials are uncertain as to whether a contemplated sale-and-leaseback conforms with this Interpretive Ruling and Policy Statement, the National Credit Union Administration Board encourages those officials to submit the sale-and-leaseback plan to the appropriate National Credit Union Administration Regional Office for review before the transaction is finalized. Such requests for review will be given prompt attention by regional office staff.

. . <u>Purpose</u>.

The purpose of this Interpretive Ruling and Policy Statement is to advise the public and credit union officials as to what the National Credit Union Administration Board considers to be a valid sale-and-leaseback arrangement, the proper accounting treatment, and the required components of the arrangement.

<u>Text of Interpretive Ruling and Policy Statement [IRPS 81-7]</u>

In accordance with Section 107(4) of the Federal Credit Union Act (12 U.S.C. 1757(4)), "A Federal credit union . . . shall have power . . . to purchase, hold and dispose of property necessary or incidental to its operations." The National Credit Union Administration Board interprets this provision to include a Federal credit union's authority to enter into a sale-and-leaseback transaction, as herein defined. The authority for federally insured state-chartered credit unions to enter into such an activity would depend on state statutes and the credit union's respective state regulatory authority. The implementation of a sale-and-leaseback transaction requires a thorough knowledge of all the risks, accounting and legal interpretations, and the advantages and disadvantages of entering into such a transaction on a long-term basis. The National Credit Union Administration Board has thus approved this Interpretive Ruling and Policy Statement for implementing a sale-and-leaseback transaction, with special emphasis being placed on the requirements for a valid sale-and-leaseback transaction. The NCUA Board recognizes that Federal credit unions have entered into sale-and-leaseback transactions in the past and wishes to caution <u>all</u> federally insured credit unions that it may interpret any past, present, and future sale-and-leaseback arrangements that are structured contrary to the provisions of this Interpretive Ruling and Policy Statement as being comprised of "unsafe and unsound" business practices. They may thus be subject to administrative remedies

available to the NCUA Board, in accordance with Section 206(b)(1) of the Federal Credit Union Act (12 U.S.C. 1786(b)(1)). The National Credit Union Administration Board also interprets Part 701.36 of the National Credit Union Administration Rules and Regulations as being applicable to sale-and-leaseback arrangements and transactions. Sale-and-leaseback transactions must thus be structured in accordance with the text that follows:

a. Definitions.

(1) Sale-and-Leaseback Transaction: Involves a two-step transaction that is essentially a financial management device. It involves the outright sale of property to an investor and the granting of a lease by the purchaser to the seller so that all the normal risks of ownership are retained by the purchaser.

(2) Substance Over Form: The economic substance of a sale-and-leaseback transaction should determine the timing, recognition, amount, and the designation of revenue. The economic or financial substance of a transaction may differ from its actual legal form. For example, a sale-and-leaseback transaction that involves a legal form of a sale may actually be, in economic substance: a construction contract; a lease of a property; an agreement to loan or borrow funds; an agreement to establish a joint venture; an agreement to divide profits in a specified ratio; a deposit on or an option to purchase an asset; a sale of something such as depreciation; a transfer of other tax deductions for income tax purposes; or a right to participate in the profits from operating an asset other than the asset that is the apparent object of the sale.

b. Conditions Conducive To Entering Into a Sale-and-Leaseback Transaction.

When a credit union builds its own building, it plans for the cost of the building by projecting income, expenses, share and loan growth over a period of time, generally 5 to 10 years. These projections are usually based on the historical performance over the previous years. When the projections are made there is no way of positively knowing what the economic situation will be at the end of the projected period. Therefore, some credit unions may find that, because of errors in estimating growth or because of other causes, they are unable to use the space that they had planned to use in future years, and in the meantime, had been renting to others. Other credit unions may have experienced periods of declining shares due to local, regional, or national economic downturns. These credit unions may thus be in a position of borrowing funds from outside sources at high interest costs. Those costs may exceed the interest income being received from loans granted to credit union members. Such credit unions are confronted with reduced earnings to pay competitive dividends and also with liquidity problems insofar as meeting members' loan and share withdrawal needs. When the credit union officials look at the overall situation, they may determine that they have encountered a tight money and earnings situation that is not expected to improve over the short run. Therefore, when they weigh their alternatives, they might find that the only prudent decision is to sell the credit union's fixed assets to improve its liquidity position and earnings capabilities. A sale-and-leaseback transaction is an excellent means of converting non-earning fixed assets into cash. It is a long-term commitment, however, and it requires careful and thorough preparation. Thus, in constructing a sale-and-leaseback transaction, one

must consider not only what the consequences will be tomorrow, but also what the impact of the sale-and-leaseback arrangement will be, for example, 20 years from now.

A sale-and-leaseback arrangement involves selling the credit union's building for the best possible price, negotiating a lease to cover a sufficiently long period of time, preserving the credit union's earnings capabilities, and providing a sufficient amount of liquidity to satisfy members' needs in order to retain their confidence in the credit union.

c. Requirements for a Valid Sale-and-Leaseback Transaction.

(1) Long-Range Planning.

A sale-and-leaseback arrangement involves long-range planning that could involve projections for periods as long as 10 to 20 years. The projections need to include estimates of the growth of shares, loans, income, and expenses. They must also include the planned activities of the credit union so that the projections will include the estimated costs of those activities and any income that will be derived therefrom.

(2) Appraisals by Qualified Independent Appraisers.

Appraisals must be made of the properties being sold and the lease being negotiated to determine whether the lease costs are comparable to the cost of available lease space in other buildings in the vicinity of the credit union's building. The appraisal should be signed and certified by an independent real estate appraiser who is a member of the Society of Real Estate Appraisers bearing the designation of "SRPA" or "SREA" or who is a member of the American Institute of Real Estate Appraisers bearing the designation of "MAI".

The Society of Real Estate Appraisers is a society composed of senior residential appraisers, senior real property appraisers, and senior real estate analysts. The senior residential appraiser (SRA) is a professional who has chosen to specialize in the appraisal of residential properties. A senior real property appraiser (SRPA) is a professional who has chosen to specialize in appraisals of income-producing properties rather than residential properties. The training and educational program necessary to achieve this designation instructs the member in the appraisal of both residential and income-producing real estate. The Senior Real Estate Analyst (SREA) is an SRPA whose practice has expanded to include all forms of appraisals as well as analytical assignments. Advanced education and experience are only two of the qualifications necessary for this unique designation. In addition, the analysts must demonstrate capability in investment analysis, marketability studies, feasibility studies, etc.

The American Institute of Real Estate Appraisers consists of members who have proved their ability to appraise varied types of property (MAIs) and those members who are specialists in appraising single- to four-family properties (RMs).

Appraisal Methodology. Three approaches to value form the foundation for current appraisal theory. These approaches are the cost approach, the market approach, and the income approach.

The cost approach is based upon the proposition that the informed purchaser will pay no more than the cost to produce a substitute property with the same utility as the subject propery. It is particularly applicable when the property being appraised involves new improvements which represent the highest and best use of the land or when relatively unique or specialized improvements are located on site for which no comparable properties exist on the market.

The market approach utilizes prices paid in actual market transactions of similar properties to estimate the market value of the subject property. This appraisal technique is dependent upon utilizing truly comparable data for sales which have occurred near enough in time to reflect market conditions relative to the time period of the subject appraisal. In essence, all approaches to value are market data approaches, since the data input is from current market conditions.

The income approach is widely applied in appraising income producing properties. Anticipated present and future income as well as any future reversions are discounted to the present value figures through the capitalization process. This approach also relies on market data to establish current economic rents and expense levels to arrive at the expected net income.

(3) Comparability Between the Maturity of the Note and the Term of the Lease.

For an arrangement to be considered a sale-and-leaseback transaction the definition of a sale-and-leaseback transaction must be considered. A sale-and-leaseback transaction is essentially a financial management device. It involves the outright sale of property to an investor and the granting of a long-term lease by the purchaser to the seller so that all normal risks of ownership are retained by the purchaser. When the lease is of a short-term nature, and the sale involves a long-term note, it is not considered to be a valid sale-and-leaseback transaction.

When the lease obligation is unduly short (unless the institution has firm documented plans to vacate upon the expiration of the lease), and the lease payments clearly guarantee the financial substance of the transaction, a sale-and-leaseback is a financing transaction. In other words, when a long-term note is offered (as indicated above) in partial payment of a purchase of fixed assets, and the corresponding lease is of a short-term nature, any resulting gain would be amortized in proportion to the amortization schedule of the note.

In making the note comparable to the lease term, it must be remembered that it is possible to make the lease terms too long, thus causing the arrangement to also be called a financing transaction. For example, when the lease term extends for more than 75 percent of the estimated useful life of a building, or the present value of the future base rental payments exceeds 90 percent or more of the fair market value, the lessor has transferred to the lessee substantially all the benefits and risks incident to ownership of the property. This is in accordance with the AICPA's

Financial Accounting Standards Board (FASB) Statement No. 13, "Accounting for Leases." When the FASB standards are compared to tax and Uniform Commercial Code interpretations, they create an invitation for a court to find that many real estate sale-and-leasebacks, unless they were carefully structured at inception, are disguised mortgage loans. Quite often courts considered the parties' accounting treatment of a sale-and-leaseback as an indication of their substantive intention. For these reasons, the maturity of the note must be comparable to the term of the lease.

(4) Multiple Bids and Offers for the Building.

The more offers and bids the credit union receives, the better the credit union officials will be able to determine which sale-and-leaseback transaction is the most beneficial for the credit union and its members. The time period allowed for accepting bids should be sufficient to allow potential buyers to prepare and present their bids for consideration. The bids and offers will aid in verifying the accuracy of the appraisal of the credit union's building.

(5) The Economics of the Lease.

As part of arranging for the sale-and-leaseback transaction, the credit union officials must determine, through an appraisal process, what the market lease cost is for their present building. This may be accomplished by having the apppraisal prepared on the basis of two premises: (1) that the credit union will continue to occupy the existing space, paying an economic rent at the terms and conditions typical of the current rental market for commercial office space; and (2) that the credit union will vacate the building, and that the space will be placed on the open market at an appropriate economic rent for non-credit union tenant(s).

If a negotiation of a sale-and-leaseback transaction results in a lease cost that is near market, or slightly below market, and the appraisal of the building is equal to market value, the only negotiable terms are the maturity of the transaction (note and/or lease) and the interest rate. The maturity of the transaction will generally follow the lending practices of commercial lenders for the type of transaction.

(6) Minimum Downpayment Requirements.

Minimum downpayment requirements must be in accordance with the AICPA's Industry and Accounting Guide for "Accounting for Profit Recognition on Sales of Real Estate." Minimum downpayment requirements are found in the main text and in Exhibit A of that publication. That publication indicates that if a single tenancy is involved, and the user has a satisfactory credit rating, that the downpayment will be 15 percent of the sales value, while other properties will have a downpayment requirement of 20 percent of the sales value.

(7) Comparability Between the Master Lease and Any Subleases.

If the sale-and-leaseback arrangement includes a master lease that covers additional office space that can be subleased, the maturities of the subleases must be comparable to that of the master lease. In other words, the master lease could

not be for a period of 5 years while the subleases are for a period of 30 years, inclusive of all options. If that were the case, the credit union holding the master lease may not be able to renew its lease and may have to depart from the building when it was still responsible for the subleases.

(8) Documentation as to Market Interest Rate.

When a sale-and-leaseback arrangement involves a note, the remaining negotiable items would be the maturity of the note, the maturity of the lease, or the interest rate on the note. The interest rate on the note should be comparable to interest rates granted on loans to parties having good credit ratings for similar type transactions within the community in which the credit union's property is located. If the interest rate is below the market interest rate for that type of transaction, there must be documentation as to why the interest rates are below market. It is not in the interest of credit union members to underbid the interest rate on a particular note, with the credit union as lessee. If the interest rate is understated, the credit union members may not receive the amount of dividends that they are entitled to because of the size and maturity of the note. Therefore, the credit union officials have an obligation to make certain that the interest rate on the note approximates the market rate that could be obtained by the lessor if he were to borrow the funds elsewhere. When a credit union negotiates a sale-and-leaseback transaction that involves a note that is payable back to the credit union, and the interest rate on the note is below market, it must document the reasons why that interest rate on the note is below market. Any resulting gain from the transaction would be subject to the AICPA's Opinion No. 21, "Interest on Receivables and Payables," thus causing a reduction in the amount of gain that is recognized at the time of sale.

(9) Arm's Length Transaction.

For a sale-and-leaseback transaction to be considered valid, it must be a transaction that is conducted at arm's length. In other words, the transaction must be reflective as though an independent lender-lessee and independent borrower-purchaser negotiated a similar transaction, under comparable terms and conditions, with the option to pay the credit union the cash price upon actual purchase or to give a note for the amount of the purchase at the prevailing rate of interest to maturity. The transaction should not be connected with any credit union officials, employees, or their relatives, nor should any credit union officials, employees, or their relatives derive monetary benefits from the transaction.

(10) Right of Tenancy for the Seller.

Each federally insured credit union that is involved in a sale-and-leaseback transaction must make certain that the contracts involving the arrangement include the right of tenancy for the selling federally insured credit union. That tenancy should approximate the maturity of any existing note, unless otherwise documented.

(11) Escalator Clauses - Cost of Living Adjustments.

In order to encourage the lessor to keep the credit union's building in a condition that is near to its original state, and to encourage an investor to become involved in a sale-and-leaseback arrangement because of higher investment earnings, it may be necessary for a seller-lessee to provide for an inflation hedge. This inflation hedge provides additional incentive over and above that which is afforded by ownership of the real estate, itself. This may be accomplished by increasing the monthly rental payments according to the Wholesale or the Consumer Price Index. It might also be accomplished by establishing periodic rental increases based on an originally agreed upon scale. If the rental increase was based on a percentage of the gross or net income of the credit union, however, the arrangement would be considered improper for a federally insured credit union, since that action would result in the assigning of earnings. If earnings increased as the result of more efficient management, the lessor would benefit partially from the change, when the credit union member should benefit fully from such an improvement.

(12) No Repurchase Agreements.

For a valid sale-and-leaseback arrangement to exist there should not be any provision in the lease or the sales agreement giving the federally insured credit union the right to purchase the building back at a future date. (In accordance with the AICPA Industry Accounting Guide entitled "Accounting for Profit Recognition on Sales of Real Estate.") A repurchase agreement may imply that the original purchaser never intended to assume the responsibilities of ownership of the building. Therefore, the validity of the sale-and-leaseback transaction is questionable and may be subject to accounting for the transaction as a financing, leasing, or profit sharing arrangement. However, this does not preclude a "right of first refusal" clause in the event that the buyer sells the property at a future time. This accounting treatment is applicable when:

(a) A seller has an obligation or an option to repurchase the property;

(b) A buyer has an option to compel the seller to repurchase the property; or

(c) A seller guarantees the return of the buyer's investment.

(13) Adherence to Generally Accepted Accounting Practices.

The sale-and-leaseback transaction must be accounted for in accordance with generally accepted accounting practices. This applies, except when statutory or regulatory requirements prevail. The sale-and-leaseback transaction must take into account the AICPA's Accounting Principles Board Opinion No. 21, "Interest on Receivables and Payables", the AICPA's Financial Accounting Standards Board's Statement No. 13, "Accounting for Leases," and the AICPA Industry Accounting Guide entitled "Accounting for Profit Recognition on Sales of Real Estate."

(14) No Senior Liens.

A sale-and-leaseback transaction involving federally insured credit unions must not include any senior liens. In other words, the purchaser must not make a downpayment with borrowed money, whereby the lender of the downpayment would obtain a lien superior to that of the lending credit union who is the seller-lessee, assuming the purchaser offers a note in partial payment of the purchase price of the asset.

(15) Adherence to Court Decisions Interpreting and Defining Valid Sale-and-Leaseback Transactions.

For a sale-and-leaseback transaction to be considered valid for a federally insured credit union, the sale-and-leaseback transaction must be in accordance with applicable laws and legal precedent that define the essence of a sale-and-leaseback transaction.

(16) Recognition of Profits and Losses in Accordance With Generally Accepted Accounting Practices.

Profits and losses on sale-and-leaseback transactions will be recognized and accounted for in accordance with the AICPA's Financial Accounting Standards Board Statement No. 13, "Accounting for Leases," its Accounting Principles Board Opinion No. 21, "Interest on Receivables and Payables," and its Industry Accounting Guide, "Accounting for Profit Recognition on Sales of Real Estate." If a loss is indicated by the arrangement, the loss will always be recognized.

The above-mentioned Industry Accounting Guide emphasizes the following:

(a) To recognize a profit on the sale of real estate, the buyer's initial investment and his continuing investment must be adequate to demonstrate his commitment to pay for the property. To be considered adequate the following factors must be considered:

(1) The relative size of the buyer's downpayment compared to the sales value of the property; and

(2) The composition of the downpayment. Funds that have been borrowed by the purchaser, or provided indirectly by the seller, cannot be included in determining the buyer's investment in the property.

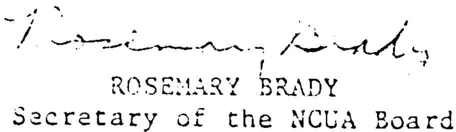
(b) Profit recognition should be postponed if the seller must perform a significant part of the contract after the time of sale.

(c) The sales contract should not be accounted for as a sale if the seller's continued involvement carries in essence the same kinds of risks as does ownership of the property.

(d) The seller can only recognize profit on the sale of real estate if the buyer is required to continue to increase his investment in the property each year after he pays an adequate downpayment.

When the buyer borrows the necessary funds from the selling credit union, the credit union will defer the gain over the term of the lease or over the term of the note, whichever is longer. Deferred gains will be recognized in proportion to the aggregate cash received (including the downpayment) to the total sales price of the property.

d. Summary. This Interpretive Ruling and Policy Statement provides the essential information requirements and considerations for credit unions contemplating sale-and-leaseback transactions. It is, again, emphasized that sale-and-leaseback transactions that are implemented by federally insured credit unions, which are contrary to the provisions stated in this text, may be considered unsafe and unsound practices by the National Credit Union Administration Board in accordance with Section 206(b)(1) of the Federal Credit Union Act (12 U.S.C. 1786(b)(1)).



ROSEMARY BRADY
Secretary of the NCUA Board

September 11, 1981