REAL ESTATE INSIGHTS

New Law Restricts Tax-Free REIT Spinoffs

In recent years, tax-free spinoffs under Sec. 355 involving REITs became popular among corporations with real estate holdings. The essence of REIT spinoffs is that valuable real estate leaves the corporation and moves tax-free into the favorable REIT tax regime. New tax legislation that took effect December 7, 2015, severely curbs this tax planning strategy.

The REIT Spinoff Transaction

The recent legislation targets the following type of transaction: a corporation conducting the core operating business (OpCo) contributes its real estate assets to a controlled subsidiary (SpinCo) in exchange for 100 percent of the SpinCo stock. OpCo then distributes the SpinCo stock to the OpCo shareholders in a tax-free spinoff transaction under Sec. 355, whereby neither OpCo nor its shareholders recognize any income or gain.

Shortly after the spinoff, SpinCo elects REIT status, and OpCo then leases the real estate from the REIT. OpCo thus makes deductible rent payments to the REIT, and the rental income passes through to the REIT investors free of corporate-level taxes. The REIT pays dividends funded by the rental income received from OpCo. Under the REIT tax regime, these dividend payments are deductible from the REIT's taxable income. Moreover, depreciation deductions for the real property held by the REIT reduce its taxable income enough to allow it to make distributions equal to, or in excess of, the REIT's taxable income to maintain REIT status. As a result, no tax is incurred at the REIT level, while taxable income is reduced at the OpCo level.

The dividends are subject to ordinary income tax rates at the shareholder level. From the shareholders' perspective, steady dividend payments from the REIT and higher valuation multiples applicable to real estate could mean that their REIT shares are potentially valued higher than they would be on a stand-alone basis without the separation.

The increasing use of REIT spinoffs by large publicly traded companies as a tax reduction strategy raised policy questions under Sec. 355 as well as concerns that these transactions were eroding the corporate tax base.

Impact of Recent Tax Law Changes

On December 18, 2015, the Consolidated Appropriations Act (the Act) was signed into law, which contains the provisions of the Protecting Americans from Tax Hikes (PATH) Act (P.L. 114-113, Div. Q). This new law includes several taxpayer favorable REIT provisions, including reforms of the Foreign Investment in Real Property Tax Act (FIRPTA) that make foreign investment in REITs more attractive, and making permanent the reduction of the recognition period for a REIT's built-in gains from 10 to five years. However, the most significant change comes in the form of the Act's restrictive provisions regarding tax-free REIT spinoffs, which make REITs generally ineligible to participate in a tax-free spinoff either as a distributing or a controlled corporation under Sec. 355.

New Law Restricts Tax-Free REIT Spinoffs cont...

Under the new law, tax-free treatment under Sec. 355 is not available where either the distributing or the controlled corporation is a REIT. There are two exceptions for existing REITs:

1. Tax-free treatment is still available for the spinoff of a REIT by another REIT where, immediately after the distribution, both the distributing and the controlled corporation are REITs.

2. A REIT may spin off its Taxable REIT Subsidiary (TRS) if (i) the distributing corporation has been a REIT at all times during the three-year period ending on the date of the distribution, (ii) the controlled corporation has been a TRS of the REIT at all times during such period, and (3) the REIT has had control of the TRS (defined in Sec. 368(c) as at least 80 percent voting power and 80 percent of the total number of shares, taking into account stock owned directly or indirectly, including through one or more partnerships) at all times during such period.

Moreover, under newly enacted Sec. 856(c)(8), if a non-REIT was a distributing or controlled corporation in a Sec. 355 transaction, that corporation (and any successor corporation) may not make a REIT election before the end of a 10-year period beginning on the date of the distribution.

These provisions took effect for distributions on or after December 7, 2015, but do not apply to transactions with a pending ruling request submitted to the IRS on or before that date. Several companies, among them Hilton Worldwide Holdings Inc. and Caesars Entertainment Corp., have requested a ruling prior to the Act's effective date to be granted IRS permission to spin off their real estate holdings.

Other companies have already started pursuing alternate strategies to monetize real estate value. Among them is publicly traded casino, hospitality and entertainment company MGM Resorts International, which has announced its plan to contribute some of its real estate assets to a newly formed REIT and to use a lease structure without a tax-free spinoff.

Conclusion

The recent legislation makes it almost impossible for an existing business to separate its operations from the ownership of real estate without incurring significant tax liability. While the restriction of tax-free REIT spinoffs marks a significant change to the restructuring environment for the real estate industry, its impact remains to be seen.

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Achieving the Best Tax Results From Tenant Improvement Allowances

Tenants who meet certain conditions can get a tax break for Tenant Improvement (TI) allowances. New lease agreements are typically viewed as routine business decisions rather than tax-saving opportunities. Ignorance of rules can prove costly to a tenant who is unaware of the potential tax implications. As an enticement to a new tenant, landlords commonly offer a TI allowance to help offset the tenant's cost of moving into the new space and fitting it to their unique needs. For leases with a term of 15 years or less, there are special tax treatments for these allowances.

Financial Reporting Versus Tax Treatment

For financial reporting purposes, generally accepted accounting principles (GAAP) typically require that an allowance used for property improvements be amortized over the life of the lease. The allowance is also recorded by the tenant as a deferred rent liability and prorated over the life of the lease. For book purposes, then, the tenant is deemed the bona fide owner of the improvements.

If tax rules followed GAAP, the tenant would be required to use a 39-year proper tax life for nonresidential real property (or 15 years, if the improvements meet the definition of qualified leasehold improvement property). Moreover, the tenant would also have to recognize the full allowance in gross income when received. Therefore, from a tax perspective, it is far more advantageous for the tenant to have the landlord own the improvements.

Section 110 of the Taxpayer Relief Act of 1997 essentially created a safe harbor for tenants. A tenant no longer needs to include in its gross income any cash amount or rent reduction used for constructing or improving qualified long-term real property.

Although disclosure is required in the taxpayer's timely filed return (including extensions), if the criteria of the section are met, the exclusion of income is automatic. Unless notified by the tenant in writing to the contrary, the landlord must capitalize the improvements for tax purposes and depreciate them over 39 years (or 15 years, if applicable).

Example 1. Imagine that ABC Corp., a landscape design firm, leases space from XYZ LLC beginning in January 2016. The lease expires in December 2025. As an incentive to ABC (the tenant), XYZ (the landlord) includes in the lease an agreement to cover $1 million of improvements that ABC will make to the space within the first year of the lease. The lease specifies that at least some portion of the allowance will be used to improve long-term real property, and notes that any portion not used can be applied by ABC against rent payments within the year. ABC uses $800,000 of the allowance, $750,000 of which is spent on Section 1250 property (depreciable real property) and $50,000 on Section 1245 property (tangible personal property). ABC applies the remainder against its December 2016 rent.

On its 2016 federal income tax return, ABC would capitalize and depreciate the $50,000 of the allowance used to purchase tangible personal property. The company would also recognize $250,000 of gross income on its return for the $200,000 applied against the December rent payment and the $50,000 capitalized. However, the $750,000 would not be treated as income or as a capital investment on ABC's return. According to Section 110, XYZ would treat the $750,000 as a fixed asset and depreciate it on its return, unless ABC agrees in writing to a different treatment. Both ABC and XYZ would attach a statement to their timely filed returns pursuant to the regulations.

Negotiations

When negotiating and executing a lease, tenants should be aware of Section 110 and should specify that at least some portion of their TI allowance will be used to construct or improve qualified long-term real property, in order to meet the purpose requirement. If this provision was missed in the master agreement, an ancillary agreement executed either with the lease or during the term of the lease is also acceptable. Although the lease agreement does not need to require the entire allowance to be used for this purpose, only the amount actually expended on qualified long-term real property will qualify under Section 110.

Example 2. Imagine that the facts are the same as in example 1, except that the lease did not specify that any portion of the TI allowance would need to be spent improving real property. In this instance, the treatment by ABC and XYZ should still be the same, but because there could be an issue under examination as to whether the purpose requirement was met, an ancillary agreement should be drawn up to cover this point.

Achieving the Best Tax Results From Tenant Improvement Allowances cont...

Excess Allowance
Any portion of the allowance that the tenant does not use within eight and a half months after the close of the tax year in which it was received, or that the tenant does not apply as a rent reduction — including amounts used to acquire Section 1245 property — will not be included under Section 110 and will be recognized as gross income.

Example 3. Again, using the same scenario as in examples 1 and 2, suppose that ABC uses the entirety of its allowance on qualifying properties by the end of the 2016 tax year, but only spends $650,000 by September 15, 2016 — eight and a half months after the year in which the proceeds were received. In this case, ABC would recognize $350,000 of gross income on its 2016 federal income tax return, as this remainder of the allowance no longer qualifies under Section 110. Tenants should be aware of this clause and should ensure that intended improvements are made within the proper time frame.

Reporting Requirements
Section 110 requires both tenant and landlord to attach a statement to their timely filed federal income tax returns, including extensions, generally providing details of the parties to the lease agreement and the allowance. Given the detailed information required in the statement, tenants should request this from the landlord at the time the agreement is signed.

What Are Qualified Improvements?
A landlord may be entitled to use the shorter life of 15 years (rather than 39 years) for some leasehold improvements they are required to depreciate under Section 110. Improvements to building interiors are considered qualified leasehold improvements if all three of the following conditions are met:

1. The landlord and tenant are not related parties.
2. The leased space is occupied exclusively by the tenant.
3. The building has been in service for more than three years.

In this case, the TI allowance could not be used to:

- Enlarge the building.
- Install an elevator or escalator.
- Construct a structural component in a common area.
- Alter the internal structural framework.

This piece originally appeared in NAIOP's Developments Magazine. Written by Jeffrey Schragg, BDO tax partner.

No Alarm Bells After Minimal Interest Rate Hike

News and predictions surrounding interest rates have dominated industry headlines for quite some time. The Federal Reserve's first interest rate hike since 2006, which arrived in mid-December after months of speculation, should act less as a cause for alarm than as a bellwether of even better things to come for the economy as a whole, as well as the CRE industry.

Because the hike is largely symbolic and indicative of the Fed's view of strengthening market fundamentals, it is not expected to hinder CRE activity. While some in the industry may be disappointed to see the end of historically low rates that helped the CRE industry recover from the Great Recession, the economy's increasingly stable footing should only help propel the industry and will outweigh any potential negative effects of the quarter-percent interest rate hike.

Though longer-term concerns could bubble up, it's unlikely that the increase will negatively or greatly impact the sector, or cause a slowdown in development or investment activity in the near term. Unemployment is falling, oil prices are expected to remain low through 2016 and housing prices have recovered in many markets, bolstering economic stability for consumers and tenants alike. Greater consumer confidence also presents the opportunity to command higher rental rates, generating better cash flow for REITs.

The potential short-term impact of the hike might have been overblown primarily because it had been top-of-mind among REITs, and industry players were well prepared for the adjustment. Many REITs have likely already factored the potential risks associated with a rate increase into their strategies, and some have already done much of the heavy lifting by preparing for a more dramatic increase than the quarter percentage point.

Assuming future hikes follow the gradual pattern discussed by the Fed of four small increases throughout 2016, the higher interest costs should be offset by increases in rental rates. This would be helped along by both inflation and strengthening economic fundamentals. If the increases in rent are greater than the incremental increases in interest costs, this would generate excess cash flow and allow REITs to pay greater dividends in the coming years.

Looking further ahead, once rates increase by another 50 or 75 basis points, REITs' risk-adjusted returns may not be as attractive to investors, and they may need to revisit their distributions. If rates were to climb higher than expected or the pace were to pick up, interest costs would be more likely to hamper REITs' valuations, distributions to shareholders and ability to finance new properties.

All things considered, one prediction to remain absolutely certain of is that the fate of rates will continue to be subject to widespread speculation and will be a key market driver for REITs in the year ahead.

This piece originally appeared in Commercial Property Executive. Stuart Eisenberg is a partner and the national leader of the BDO Real Estate and Construction practice.

What's Trending in Real Estate Around the World? - Canada

Each quarter, Real Estate Monitor will feature the top trends impacting real estate in an increasingly global market, as reported by our international colleagues. For this issue, we sat down with Salmaan Alvi, BDO Canada's National Real Estate and Construction practice leader, to discuss the four leading trends he says are influencing the Canadian real estate market today.

Consumers are Pulling Back on the Purse Strings
Consumer debt in Canada has surpassed that of the United States. Spending on the lower end has dropped as consumers have shied away from the excess they may have embraced a few years back. That said, there is a prevailing wind of cautious optimism, mirroring what's being seen in the U.S. economy.

Foreign Investors Capitalize on the Deflated Loonie
Despite concerns that Canada could be facing a real estate bubble, foreign buyers are willing to pay a premium for in-demand properties, and we could continue to see more inbound money. China remains the top player, but we're also seeing significant investment from the Middle East.

Millennial Preferences are Reshaping Real Estate
Millennials' growing preference for multi-family urban living that caters to the live-work-play mindset is leaving its mark on Canada's residential real estate market. It is also impacting office space: as more people gravitate back toward urban markets, so do the employers that once inhabited suburban office parks.

How Low Can They Go? Oil Prices Bring Mixed Impact
In major markets like Toronto and Vancouver, low global oil prices are creating ripple effects reaching across the broader economy. But overall, low oil prices are benefitting most industries, as is the case in the United States. Also similar to the U.S. is the effect of low prices on boom towns that over-constructed to accommodate the influx in oil sands workers before prices crashed. For example, Alberta, historically heavily oil-driven, is experiencing double-digit vacancies.

Perspective in Real Estate

The $7.6 trillion hospitality industry is in the grips of a merger frenzy, with players from hotels to online bookings to car rentals and cruise liners seeking to increase their share of a fragmented, increasingly competitive and globalized market.

Room rates and occupancy levels are at all-time highs, but the rise of home-sharing platforms like Airbnb is putting pressure on lower-priced and leisure brands. Many firms view scale as the best way to compete, according to MarketWatch.

There have been several major deals in the last six months. Marriot International acquired the much sought-after Starwood Hotels & Resorts Worldwide for $12.2 billion, and the Blackstone Group paid $6 billion for real estate investment trust (REIT) Strategic Hotels and Resorts. Expedia has also gotten into the M&A game, purchasing vacation home rentals company HomeAway for $4 billion.

Most of the major hospitality companies are no longer in the business of hotel ownership, preferring instead to collect fees from management contracts or franchise their brands. This enables them to offer more global exposure and a larger customer base to entice new hotel owners to their brands, according to MarketWatch. Strategic buyers have also revised their consolidation strategies to compete with the rise of the sharing economy. For example, Wyndham Worldwide recently invested $7.5 million in home exchange company Love Home Swap, and Enterprise Holdings bought several ride-sharing companies in addition to launching its own.

Ratings agency Fitch expects hospitality M&A activity to remain high in the near term, as firms fight for control of the market in an evolving competitive landscape and navigate the rapid growth in alternative lodging accommodations like Airbnb, reports Private Equity Wire. While megadeals grab headlines, mid-size hotel companies are attractive targets for private equity firms that might not be able to swallow such massive deals.

Private equity firms are expected to favor investments in hotel REITs, as they did during the last wave of hotel consolidation a decade ago, betting that real estate holdings are more valuable than the market values of the companies themselves. The last cycle peaked with the privatization of Hilton in 2007, when–in the biggest hotel deal ever–Blackstone paid more than $18 billion plus $7 billion in assumed debt. Some analysts believe this dynamic has returned and could fuel further consolidation and privatization of hotel REITs in the near term, MarketWatch reports.

REITs make attractive PE targets because they have better access than corporates to low-cost debt and valuations are generally at a discount compared with net asset values, according to Private Equity Wire. With record amounts of capital raised for commercial real estate platforms in recent years, many buyout shops are now looking to put it to work, including through REIT privatizations, Private Equity Wire reports.

PErspective in Real Estate is a feature examining the role of private equity in the real estate industry.

Sources: Private Equity Wire, MarketWatch, Financial Times, Travel Daily News, Huffington Post, JLL Real Views.