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REIT Transfer Pricing

Planning and Considerations for Management Recovering From the Impact of COVID-19

The COVID-19 pandemic has impacted real estate investment trusts (REITs) in different ways. Volatility in earnings, valuations and cash flows are compelling REITs to be continually engaged in both short-term and long-term planning. One aspect of planning includes evaluating the arm's length nature of the intercompany arrangements between a REIT and its taxable REIT subsidiaries (TRS). REITs with intercompany arrangements, particularly those in the lodging and healthcare space, repeatedly are asked by their auditors and tax advisors if they have reviewed their intercompany rental arrangements to determine whether they meet the arm's length standard. This question is often a refresher for a REIT's management team to evaluate the risks associated with their intercompany arrangements to the extent they are not at arm's length.

The "REIT Investment Diversification and Empowerment Act" of 2007 (RIDEA) essentially provided guidance allowing a REIT to lease property to its TRS and treat the rent as qualifying 75% gross income if the property is a qualified healthcare or lodging facility¹ and the property is managed by an eligible independent contractor². This structure is commonly referred to as a standard PROPCO/OPCO structure. In this structure, the REIT [PROPCO], which is the owner of the real estate, enters into an arm's length transaction to lease the property to the TRS [OPCO], which indirectly operates the healthcare or lodging facility through an eligible independent contractor.

The TRS, which is a corporation, would be subject to corporate-level tax on the net income generated.

The rent paid by the TRS to the REIT must meet the "substantial comparability requirement"³ or be subject to a 100% excise tax imposed under Internal Revenue Code (IRC) Section 857. As such, the rent paid by a TRS to the REIT must be substantially comparable to such rents paid by the other tenants of the trust's property for comparable space. The 100% excise tax would be assessed by the Internal Revenue Service (IRS) on any amount of "redetermined rent" that was not set at arm's length.

To reduce the risk of audit, the best defense is having an updated transfer pricing study. IRC Section 482 provides the statutory framework that governs the arm's length nature of these intercompany arrangements. The guidance included in the IRS regulations⁴ allow for various testing methodologies to determine arm's length nature of an intercompany transaction. Generally, the most common benchmarks used to evaluate intercompany rents are third-party comparables. Careful consideration should be given as to whether lease modifications satisfy the arm's length standard under IRC Section 482. It should be noted that recently the Organisation for Economic Co-operation and Development (OECD) endorsed the use of "transfer pricing adjustments" to help taxpayers through the challenges of COVID-19⁵.

In addition to the tax audit risk associated with the 100% excise tax on redetermined rent, there are a few other reasons to consider updating a REITs transfer pricing.

- **Liquidity Management** – In a flourishing market, the TRS could be paying below-market rent to the REIT, thus creating excess cash, earnings and taxable income at the TRS level.
- **Improvement to Financial Earnings** – REITs may be able to improve their short-term financial earnings to the extent they are able to release valuation allowances (VAs) that have built up over time for tax provision purposes, thus creating a tax benefit. These VAs are a result of TRS net operating losses (NOL) created by above-market leases paid to the REIT.

The release of the valuation allowance could create a net tax benefit while the TRS still relies on NOLs to offset taxable income.

- **Requirement with SOX Controls (Public Companies)** – Good SOX controls should include language for REITs to annually review their intercompany arrangements to determine that they are, and will continue to be, at arm's length.

Lodging and Healthcare REITs are beginning to see an increase in cash flows as they gradually recover from the shelter-in-place orders that had significantly hampered cash flows during the peak of the pandemic. Leases entered into prior to the pandemic, or renegotiated based on the uncertainty of the pandemic, may no longer be considered arm's length.

FTI Consulting's Transfer Pricing team can perform a comprehensive review of leases, including, but not limited to, modeling and benchmarking upward and downward scenarios, then documenting the scenarios with a transfer pricing report.

¹IRC §856(d)(9)(D) and IRC §856(e)(6)(D)(i)

²IRC §856(d)(9)(A)

³IRC §856(d)(8)(A)(ii)

⁴Reg §1.482

⁵See OECD, "Guidance on the transfer pricing implications of the COVID-19 pandemic," December 18, 2020, at <http://www.oecd.org/tax/transfer-pricing/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic.htm>

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