

# Business Disruption: Transfer pricing issues and considerations for the real estate investment trust industry

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## In brief

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The current crisis has caused significant business disruption for almost every industry, but with particular impact on certain industries. Many real estate investment trusts (REITs) face difficulties as their tenants struggle to meet lease obligations, their real estate assets decline in value, and the ability of their employees to work remotely is challenged. Like many other businesses, REITs must adjust their operations to deal with business disruption arising from the current environment.

For a REIT that has taxable REIT subsidiaries (TRSs), its transfer pricing policies can play a key role in its ability to respond to these challenges. This is because TRSs provide REITs with the increased operational flexibility to enter into transactions that may not be permissible for the REIT itself. However, when REITs enter into — or revise — transactions with TRSs based on changes in market conditions, careful consideration should be given to the rules governing the taxation of REITs and TRSs under Sections 856 and 857, as well as the transfer pricing rules under Section 482. Not doing so could result in unexpected excise taxes, REIT compliance concerns, and liquidity issues.

The following summarizes common transactions between REITs and TRSs and key issues that should be considered from an income tax perspective.

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## In detail

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### Leases of property from a REIT to a TRS

Leases from REITs to TRSs are prevalent where a REIT holds certain classes of property, such as hotels or assisted living facilities. In these cases, the REIT often leases the entire property to the TRS. However, intercompany leases are not exclusive to these classes of property. Other REITs may lease space within their properties to TRSs to operate other ancillary businesses (e.g., restaurants, office space, and conference facilities).

Many REITs that rely on intercompany leases face significant business disruption in the current environment. Lodging REITs may have arguably been hit the hardest, as shelter-in-place orders have drastically reduced travel and occupancy rates have fallen to their lowest levels in decades. Healthcare REITs focused on senior living also face significant business disruption, as sections of their properties may have been shut down to prevent the spread of infection among tenants. Without the ability to

generate sufficient revenues, a TRS may struggle to meet its lease obligations to the REIT, which in turn can cause numerous issues.

In seeking to prevent unintended, adverse tax consequences arising from these difficult business circumstances, REITs should monitor their compliance with REIT qualification requirements and consider the arm's-length nature of any modifications to intercompany lease arrangements. For instance, if a TRS stops making rental payments to the REIT without modifying their lease agreement and the REIT continues to accrue rental income from such leases for income tax purposes, the REIT's 90% distribution requirement could be implicated and potentially cause liquidity issues (e.g., if the REIT's available cash is less than the amount the REIT must distribute to satisfy the 90% distribution requirement).

**Observation:** Modifying lease arrangements between the REIT and TRS — for example, abating rental payments for a period of time — may provide some liquidity relief with respect to this distribution requirement. However, in any such modification, careful consideration should be given to whether the modification satisfies the arm's-length standard under Section 482. Additionally, appropriate accompanying documentation should be prepared, especially given that failure to establish the arm's-length nature of a lease modification could result in a REIT being subject to a 100% excise tax risk arising from a transfer pricing adjustment or having the adjusted rental amounts disqualified as REIT-qualifying income.

### Intercompany services and expense sharing arrangements between a REIT and TRS

Intercompany services are common arrangements between a REIT and its TRS, with the TRS often providing services to or on behalf of a REIT. Often the services provided by the TRS relate to non-customary services to boost the attractiveness of the REIT's properties (e.g., cafeteria services, transportation services, and security services). In addition, a TRS can generate income that would be non-qualifying income from property management, leasing services, construction and development, and asset management. Services performed by a TRS for its REIT can be particularly important to attract tenants and investors for many types of REITs, including those in the retail, office, and multifamily sectors. Depending on the organizational structure of the REIT, TRS arrangements also may give rise to intercompany expense sharing arrangements, since the costs of certain individuals may relate to the activities of multiple entities within the organization.

However, given the shelter-in-place orders, many REITs are struggling with their supply chain and the inability of TRSs to continue to perform revenue-generating services. In some cases, retail stores have completely shut down; in other cases, construction and development of office properties have temporarily ceased. Although somewhat more insulated from this type of business disruption, multifamily properties are affected by growing unemployment rates, creating difficulties for property managers. As these REIT sectors deal with their supply chain issues, cash flow preservation has become their number one priority. Therefore, there is a growing trend to reevaluate the effectiveness of a REIT's service providers (related parties or otherwise) to maintain operations and preserve cash flow.

**Observation:** Evaluation of the arm's-length nature of compensation due to TRS service providers from a Section 482 perspective should take into account broader economic circumstances and the experience of similar independent service providers in the current landscape. It is important that a REIT use the best transfer pricing method considering the particular type of intercompany arrangement and the comparability and reliability of third-party data. Other pricing considerations for intercompany services include updating the third-party benchmarks (e.g., cost plus, bps of AUM) given recent market volatility. In addition, the allocation keys associated with expense sharing arrangements should be revisited as the prior allocation keys (e.g., time studies, revenues, or assets) no longer may reflect current economic activity and/or the anticipated benefits of the services in the current environment.

### Intercompany funding considerations between a REIT and TRS

REITs often extend loans to assist a TRS with its working capital requirements for operations. Intercompany loans also can be used to acquire assets that may not be considered 'good' REIT assets (such as personal property), or assets that may be subject to a prohibited transactions tax if held by a REIT. In some cases, a TRS may loan cash to its REIT parent.

Liquidity management is paramount for all REITs under current market conditions. Liquidity management is of particular importance for mortgage REITs, as they are dealing with margin calls on their repo lines and, in some cases, have been compelled to sell their assets at distressed prices. Their liquidity needs are magnified by the tax impact of their transactions, as capital losses from these distressed sales cannot offset ordinary income from their normal operations. In

light of these issues, many mortgage REITs have relied on intercompany loans to fund activities in a TRS, such as the origination of agency loans that eventually are sold to government-sponsored agencies, and/or to fund the acquisition of distressed assets from the REIT that may be subject to eventual loan workouts.

From an income tax perspective, there are several items to consider in relation to putting into place, or modifying, loans between REITs and TRSs. From a transfer pricing perspective, both the quantum of the principal amount and the interest rate should be analyzed. Analysis of the principal amount typically would entail a financial analysis of factors that have been considered in numerous cases focused on debt determinations, including the borrower's cash flows, capital structure relative to its peers, and the ability to underwrite such an amount under current market conditions. The interest rate analysis involves evaluation of the likelihood of repayment, the use of commercial terms and conditions of similar loans, and the benchmarking of interest rates through comparable third-party arrangements.

**Observation:** Beyond Section 482, the interest limitations under the tax rules, including Section 163(j), should be considered as these rules limit business interest deductions for taxpayers. The most recent CARES Act has increased the Section 163(j) limit from 30% of EBITDA to 50% for tax years 2019 and 2020 (with special rules for partners and partnerships for 2019), providing much-needed relief for capital-intensive businesses during current economic conditions. Section 163(j) is of particular importance for TRS borrowers that may be engaged in operations that may not be eligible for the real estate exemption status.

Finally, in connection with any revisions to loans, consideration should be given as to whether the change is a substantial modification that would be treated as a taxable transaction, whether there is any cancellation of indebtedness income, and whether the lender may be entitled to a deduction for the bad debt.

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### The takeaway

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REITs are responding to the current environment by modifying their operations and preserving their liquidity in a manner designed to be compliant with REIT rules. In doing so, REITs with TRSs should consider the transfer pricing implications of such modifications in light of current market conditions.

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## Let's talk

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For a deeper discussion of how this issue might affect your business, please contact:

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