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Transfer Pricing Considerations for Lease Structuring: COVID-19 Lessons

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In this article, Moalusi examines how the pandemic affected the real estate investment trust industry and various lease restructuring options from a transfer pricing perspective, and he recommends best practices to minimize the effect of economic downturns on operations.

I. Introduction

A lease can generally be described as a contractual arrangement that gives the lessee the right to use an asset in exchange for payment to the lessor. Lessors and lessees may enter into short-term (up to 12 months) or long-term (greater than 12 months) lease agreements. There are some benefits and drawbacks to each of these types of leases.

For lessees the benefits of long-term versus short-term leases include stability, for example, by locking in the rent payment for longer periods and enabling the lessee to stay in one location for longer periods. In long-term leases, lessors may be more inclined to offer rent discounts because the lessee is committing to a longer term.

Short-term leases tend to provide more flexibility for lessees, enabling them to renegotiate rent or move to more affordable or convenient locations quickly. On the other hand, for lessors, long-term leases tend to offer more income consistency. Also, long-term leases offer less of an administrative burden to lessors. Conversely, short-term leases allow lessors the flexibility to raise rents, evict uncooperative lessees, or renegotiate lease terms more quickly. Lessees may also need to make some long-term investments, such as leasehold improvements on the property, which would make a long-term lease more desirable.

Congress created real estate investment trusts in 1960. In 1999 Congress passed the REIT Modernization Act (RMA) with the purpose of defining and broadening how a REIT can use its taxable REIT subsidiary (TRS) to compete fairly with investments offering the same services, while also limiting the dominance of REITs in the market and their ability to overcharge for services. Therefore, the RMA gave REITs the right to own TRSs, which are subject to corporate tax but not to any of the REIT qualification tests. The RMA allows REITs to offer a range of "non-permissible" services to their tenants through the TRSs without jeopardizing their REIT status. Also, a REIT may lease a limited portion of a property to its TRS if the rent paid by the TRS is "substantially comparable to such rents paid by the other tenants of the [REIT's] property for comparable space."[1]

Finally, REITs are now permitted to lease hotels and healthcare properties, such as assisted living facilities, to their TRSs in exchange for market rents, provided that the leased properties are operated by active third-party managers. However, to ensure the income of a TRS isn't reduced through transactions with its REIT parent, Congress imposed a 100 percent tax on the amount from a TRS that exceeds what an unrelated third party would have paid in an arm's-length transaction.

From a transfer pricing perspective, REITs transact with their TRSs as lessor and lessee,

[1] Section 856(d)(8)(A)(ii).

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respectively.[2] This creates the need to ensure that the rent payment is structured to be consistent with the arm's-length standard. Under section 856(d)(8)(A)(ii), when a REIT leases a portion of its property to a TRS,[3] the rent paid by the TRS to the REIT must be comparable with that paid by third-party lessees of the REIT. This is akin to requiring that the REIT and TRS act in an arm's-length manner when it comes to how they structure leasing arrangements, and that the resulting rent must reflect an arm's-length payment.

Also, to support the arm's-length position taken by the REIT and TRS on the lease structure, it is critical to demonstrate that the prevailing industry or economic conditions warrant such a modification by establishing a framework for documenting the position taken by the REIT and the TRS in structuring the rent payment.

In an economic downturn significant business disruptions and challenges often influence lessors to provide concessions to lessees. The COVID-19 pandemic affected some sectors of the REIT industry significantly. REITs that own hotels, retail facilities, restaurants, and assisted living facilities have been negatively affected by factors like travel restrictions, stay-at-home orders, and significant income decreases caused by unemployment.

Those factors caused lessees of the facilities to face difficulties meeting their lease obligations because their income was reduced as a result of the business disruptions. Therefore, to keep lessees in the buildings and to continue receiving some income during the economic downturn, lessors may be willing to modify terms or provide concessions for current leases.[4] For instance, during 2020, some REITs indicated that they reached agreements with their third-party tenants to defer rent due as COVID-19 continued to put downward pressure on the income generated by these tenants.[5] This allowed the lessees to continue operating, while at the same time providing some income to the REITs.

To make it easier for lessees to enter into new leases, the parties may negotiate terms containing concessions by lessors. Lease modifications and concessions may take different forms, including the following:

1. rent forgiveness;
2. rent abatement;
3. rent deferrals;
4. base rent reductions;
5. short-term lease extensions; and
6. combinations of the above.

According to Financial Accounting Standards Board, rent forgiveness and rent deferral are expected to be the most common types of concessions granted to lessees during the pandemic.[6] FASB indicates that when rent payment changes are made after a lease begins, they are generally accounted for as lease modifications under accounting standards codification (ASC) Topic 842.[7] This is particularly the case if a lessor grants concessions that are beyond the enforceable rights and obligations of the lease contract. In the case of an economic downturn, such as that caused by the pandemic, these are generally unforeseen events that may not be written into a lease contract. Therefore, such events may be treated as lease modifications and are allowed under ASC Topic 842.

II. Lease Modifications

Similar to transactions between unrelated parties, the REIT and TRS may enter into a lease modification agreement to provide that rents don't accrue and aren't required to be paid for a specified period (rent holiday period). During the rent holiday, the lessor generally isn't required to take those rents into account for federal income tax purposes. However, temporary forbearance or deferral of the rent due, without modifying the

[2] Note that the lessor/lessee relationship exists only for certain property types as there isn't always a lease relationship between a REIT and a TRS.

[3] Section 856(d)(8)(A)(i) states that at least 90 percent of the leased space must be leased to persons other than the TRS and those related to the REIT.

[4] As an example, Welltower indicated it collected approximately 97 percent of the rent due from operators under triple-net lease arrangements, including senior housing and post-acute-care facilities. Welltower Inc., "Welltower Reports Fourth Quarter 2020 Results" (Feb. 9, 2021).

[5] Madeleine Farman, "EPR Properties Sees 21 Percent of Rent Paid by Customers in Q2," S&P Global Market Intelligence (Aug. 6, 2020).

[6] FASB, "Topic 842 and Topic 840: Accounting for Lease Concessions Related to the Effects of the COVID-19 Pandemic" (Apr. 2020).

[7] ASC Topic 842 is the FASB's account standard for leases. FASB exposure draft, "Leases (Topic 842): A Revision of the 2010 Proposed Accounting Standards Update, Leases (Topic 840)" (May 16, 2013).

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lease agreement for the amount of rent for such period, is unlikely to be sufficient to prevent the lessor from continuing to accrue rental income subject to section 451 or 467.

Lease modification agreements should specify that any increases in rent for subsequent rental periods that are intended to be an offset for the lack of rents during the holiday period are legally for the use of the leased property for those subsequent rental periods rather than for the rent holiday period. It is important that the modification not refer to the payments made in the subsequent rental periods as deferred payments relating to the use of the property for a prior period. Otherwise, the lessor may have to accrue the rent payment as income for the prior period and be subject to tax for that period.[8]

A. Rent Forgiveness

In this arrangement, the lessor forgives the rent payment due from a lessee for a specified period.

B. Rent Abatement

In a rent abatement arrangement, the lessor agrees to temporarily reduce the rent payment due, such as for a specified period during an economic downturn.

C. Rent Deferral

In this arrangement, the lessor defers rent payments for a specified period. After that period, the lessee pays the normal rent, plus an agreed proportion of the deferred rent over a given period.

D. Base Rent Reductions

Base rent can be defined as the rental rate that a lessee agrees to pay to the lessor before any additional operating expenses or revenue percentages each month. In REIT leasing structures, base rent is usually a fixed amount that the lessee has to pay regardless of its income. During economic downturns, the lessor may extend concessions to the lessee by reducing the base rent for a specified period, giving much-needed relief to the lessee, which is likely generating low income or even losses.

E. Lease Term Modifications

Term modifications are typically offered in combination with other measures to compensate the lessor for loss of income as a result of concessions made. For instance, if a lessor agrees to rent forgiveness over a specified period, the lessor may request a lease extension from the lessee to compensate. In other cases, a lessor may agree to a shorter lease term, allowing for the ability to reset the rent payment when the current term expires.

III. Lessons Learned During COVID-19

During 2020 and in early 2021, as COVID-19 continued to affect the healthcare system and the economy in the United States and globally, it became apparent to many REITs that they needed to review existing leases, and for those REITs and TRSs that were intending to enter into new leases to reevaluate how these leases would be structured. The responses we have seen so far among REITs and their TRSs, consistent with what unrelated industry players have done in some cases,[9] include rent forgiveness, rent deferral, and shortening of potential lease terms allowing the parties to reset the lease structure more quickly. In the following sections, we discuss two scenarios from a transfer pricing perspective: rent forgiveness and rent deferral.

A. Rent Forgiveness[10]

As described, rent forgiveness occurs when a lessor forgives payment of rent for a specified period. This may occur for a lease agreement that is already in place, when the economics of the lease structure are negatively affected by the prevailing market conditions and the projected financial information indicates that a lessee would be unable to sustain the rent payments. In the following illustration, we discuss a rent

[8] The discussion in this article isn't intended to cover tax treatment of payments and potential deductions caused by lease modifications; however, the reader should note that this is an important aspect that must be considered when dealing with lease modifications.

[9] Welltower, *supra* note 4.

[10] Credit to Ken O'Hara, Santi Chandra, Ariana Kishfy, and Kathryn Peaquin.

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forgiveness example encountered for a senior and assisted living operation.

In this example, there was a lease in place. The TRS (lessee) in this case faced some significant adverse economic risks because of the pandemic. Senior and assisted living facilities operators fall within the retirement community industry in the United States. This industry primarily provides residential and personal care services for the elderly and other individuals who are unable to fully care for themselves or who desire to live in a community facility. According to IBISWorld, in the five years before 2020, the retirement community industry in the United States experienced significant growth, primarily because of an aging population in the United States, with growing needs. Conditions such as Alzheimer's and dementia have also led to an increased need for round-the-clock care and put a greater demand for services from providers.[11] As the pandemic hit in the first quarter of 2020 in the United States, operators started to face cost pressure, because they were forced to spend more on labor and personal protective equipment. Also, because of concerns related to the ease with which COVID-19 can spread and infect, families were hesitant to move their seniors or seniors themselves were hesitant to move into retirement communities, which led to substantial decreases in occupancy rates.

Other factors such as the decrease in disposable income for many families as unemployment increased, and the heightened regulatory environment as government agencies were looking to protect the health and safety of residents in these facilities, put downward pressure on revenue and raised costs for operators during 2020. This dip in revenue translated into decreased cash flows for TRSs and presented them with a challenge to meet their rent obligations. These observations are consistent with those of REITs and their unrelated tenants. For instance, on February 9, 2021, in its fourth quarter disclosure, Welltower stated:

> In the Outpatient Medical segment we collected over 98 percent of rent due in the fourth quarter, with uncollected amounts primarily attributable to local jurisdictions with COVID-19 related ordinances providing temporary rent relief to tenants. In most cases, approved and executed Outpatient Medical rent deferrals from earlier in the year represented two months of rent which was generally repaid in full by year end. We collected over 99 percent of deferred rent due in the fourth quarter.[12]

B. Analysis

In this example, to illustrate that rent forgiveness is reasonable and consistent with arm's-length principles, an evaluation of the economic and regulatory environment during the four quarters of 2020 was performed.

1. Quarter 1: January-March 2020

As Q1 rolled around, COVID-19 had not yet affected the United States. During January and February, although it was known that COVID-19 had been discovered in China, there were still no significant numbers of reported cases[13] in the United States. Thus, during the first two months of the year, the economy and society at large were operating in a steady state. However, toward the end of Q1 the United States experienced more cases of COVID-19; for example, on March 6 it was reported that 21 passengers on a cruise ship off California had tested positive. By the end of Q1 the Senate had passed the Coronavirus Aid, Relief, and Economic Security Act, which provided about $2 trillion in aid to hospitals, small businesses, and state and local governments. The CARES Act was signed into law by President Trump on March 27.

2. Quarter 2: April-June 2020

At the beginning of Q2, the number of COVID-19 infections began to rise significantly, and the effects of the virus began to be realized. In an attempt to limit or stop the spread of the virus, many leaders, states, and local governments began to encourage mask wearing and social distancing. Also, the State Department issued a

[11] IBISWorld, "Retirement Communities in the U.S. — Industry Market Research Report" (Dec. 2020).

[12] Welltower, *supra* note 4.

[13] Note that the first case of COVID-19 in the United States was reported on January 21, 2020, in Washington state.

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global level 3 health crisis restriction on traveling; state leaders instituted stay-at-home mandates; many businesses were forced to close because of the virus. Millions of Americans began to face unemployment as businesses were shutting down and couldn't sustain existing employment levels. Qualified businesses and individuals started to receive financial support from the federal government under the CARES Act. It is worth noting that while some of the federal mandates under the CARES Act provided temporary direct or indirect relief to residents in senior and assisted living facilities or their families, those mandates didn't apply to the facilities themselves. However, some facilities were able to access funds provided through the CARES Act's Paycheck Protection Program, which provided them with cash flow to continue covering employee salaries for a limited time.[14] These funds still didn't cover additional costs such as personal protective equipment during the peak of COVID-19. Thus, the mandates didn't fully counteract the depressed demand of the industry and the high-risk nature of senior and assisted living facilities.

3. Quarter 3: July-September 2020

In Q3, the number of COVID-19 infections was rising and deaths from the virus were also significantly rising, with the United States recording the most infections and deaths globally. Some relief measures from the CARES Act were also expiring, which implied that Americans who would have qualified for these measures now had less economic support from the federal government. Thus, many families who would have put relief funds toward the payment of rent for elderly care no longer had the additional funds to do so. Also, there were no further mandates or moratoriums to pardon the nonpayment of rent for residents of the assisted living facilities or for expense relief for the assisted living facilities themselves. Therefore, these factors exacerbated the cashflow shortage problems faced by senior and assisted living facilities.

4. Quarter 4: October-December 2020

Q4 brought with it some significant factors that affected the economic outlook in the United States. President Biden was elected in November; most relief programs instituted as part of the CARES Act expired; and Americans had little additional economic support from the federal government, aside from benefits that would be received in a non-pandemic society (such as welfare programs). The count of positive COVID-19 cases continued to rise and reached daily historic numbers. Also, no further mandates or moratoriums were released to pardon the nonpayment of rent for residents of the senior and assisted facilities or expense relief for those facilities.

However, there was also positive news, as Biden hinted that he would push for another round of relief packages to assist businesses and families. Also, pharmaceutical companies such as Pfizer, Johnson & Johnson, and Moderna had developed vaccines for COVID-19. On December 11, the Food and Drug Administration approved the Pfizer vaccine to be distributed in the United States. On December 18, the FDA also approved the distribution of the Moderna vaccine. These two events gave hope that the spread of the virus could be curbed. However, even with these developments, the effect on the economy and societal norms such as social distancing, travel restrictions, and work-from-home arrangements were still in place. Therefore, during Q4 the substantiating effects of COVID-19 coupled with little federal government assistance continued to negatively affect the senior and assisted facilities such that they could not immediately get back to normal operation.

Based on those observations, the recommendation was that the TRS could receive rent adjustments, consistent with how third parties[15] would behave on an arm's-length basis in similar market conditions. Therefore, in this case it was concluded that rent forgiveness for six to 12 months is reasonable. Rent forgiveness from the REIT to the TRS during this time would provide much-needed financial relief and be viewed as consistent with how third parties would behave.

[14] Tim Regan, "PPP Funds Cast Financial Lifeline to Senior Living Providers During Covid-19," *Senior Housing News*, May 13, 2020.

[15] Farman, *supra* note 5.

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The final step in this process was to perform an analysis of the TRS's financial position to determine how rent forgiveness for a six-month period and a 12-month period would affect the TRS's operating margin (OM). Table 1 provides an illustration of this analysis.

Table 1. Unadjusted Results (USD — 12 months)

Line Item	Variable	Results
Total income	[A]	$4,990,000
Total operating expenses (excluding rent)	[B]	$4,800,000
Rent expense	[C]	$950,000
Depreciation and amortization	[D]	$320,000
Earnings before interest and taxes (EBIT)	[E] = [A - B - C - D]	-$1,080,000
Operating margin	[F] = [E/A]	-21.6%

As indicated in Table 1, the TRS's unadjusted results indicated a negative 21.6 percent operating margin, caused by negative revenue generation resulting from the COVID-19 pandemic.

The next step in the analysis was to evaluate how six or 12 months of rent forgiveness would improve the OM. Tables 2 and 3 show these analyses.

Table 2. Adjusted Results — Six-Month Rent Forgiveness

Line Item	Variable	Results
Total income	[A]	$4,990,000
Total operating expenses (excluding rent)	[B]	$4,800,000
Rent expense	[G] = [C/2]	$475,000
Depreciation and amortization	[D]	$320,000
EBIT	[H] = [A - B - G - D]	-$605,000
Operating margin	[I] = [H/A]	-12.1%

With six months of rent forgiveness, the operating margin of the TRS would be improved from negative 21.6 percent to negative 12.1 percent. Therefore, the six-month rent forgiveness does provide some relief.

Table 3. Adjusted Results — 12-Month Rent Forgiveness

Line Item	Variable	Results
Total income	[A]	$4,990,000
Total operating expenses (excluding rent)	[B]	$4,800,000
Rent expense	[J] = [C * 0]	$0
Depreciation and amortization	[D]	$320,000
EBIT	[K] = [A - B - J - D]	-$130,000
Operating margin	[L] = [K/A]	-2.6%

With 12 months of rent forgiveness, the operating margin of the TRS would be improved from negative 21.6 percent to negative 2.6 percent. Therefore, the 12-month rent forgiveness provides an even better relief on the burden caused by COVID-19 to the TRS.

It must be emphasized that for REIT qualification purposes, the determination of rents payable or paid by the TRS cannot depend in whole or in part on the income or profits of the TRS. Thus, while the above illustrates the impact of a rent forgiveness on the operating result, the amount of the forgiveness shouldn't be determined based on actual revenue and expenses.

C. Rent Deferral[16]

In a rent deferral, the REIT defers requiring rent payments from the TRS for a specified period. After that period, the TRS then makes the normal rent payment, plus an agreed proportion of the deferred rent payment over a given period.

In this example, a new lease agreement was being contemplated between the REIT and the TRS for a hotel property. The pandemic caused the property to experience a significant decrease in occupancy rates. Thus, the financial projections indicated that for 2021, the first year of the

[16] Credit to Rui Fan, Sharon Liu, Tommy Tang, and Alex Ryan.

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Table 4. Derivation of Implied Rent Payments

Line Item	Variable	Projected Financial Information		
		Lease Period Ending		
		Dec. 2021	Dec. 2022	Dec. 2023
Revenue	[A]	$8,250,600	$12,100,000	$14,070,100
Total operating profit	[B]	-$380,000	$1,750,970	$2,720,870
Independent Companies' IQR of Operating Margins				
Lower quartile		1.3%	1.3%	1.3%
Median	[C]	3.8%	3.8%	3.8%
Upper quartile		6.0%	6.0%	6.0%
Target Operating Profit After Rent Payment				
Lower quartile		$107,258	$157,300	$182,911
Median	[D] = [A * C]	$313,523	$459,800	$534,664
Upper quartile		$495,036	$726,000	$844,206
Range of Implied Rent Payment				
Lower quartile		-$487,258	$1,593,670	$2,537,959
Median	[E] = [B - D]	-$693,523	$1,291,170	$2,186,206
Upper quartile		-$875,036	$1,024,970	$1,876,664
Range of Adjusted Implied Rent Payment				
Lower quartile		$0	$1,311,854	$2,256,143
Median	[F]	$0	$890,057	$1,785,093
Upper quartile		$0	$518,875	$1,370,569

proposed three-year lease period, the TRS would have negative operating profit.

To derive the implied rent payments for the three-year period, the analysis first determined the level of operating profit that the TRS would have to earn to achieve a profit level that falls within the interquartile range of operating margins established by the comparable independent companies. This analysis started by applying the lower quartile, the median, and the upper quartile of the interquartile range of operating margins established by the comparable independent companies to the TRS's projected revenue for each year. That results in the derivation of the range of expected operating profit for the TRS in each year. The following formula presents the calculation to derive this range:

Revenue * OM = Target Operating Profit[17]

Once the range of expected operating profit for the TRS was determined, the implied rent is calculated by subtracting the expected operating profit for each year from the operating profit as determined by the projected financial information.

Thus, the implied rent for each year is derived using the following formula:

[17] Note that to derive the range of expected operating profit in each year, the revenue in each year is multiplied by each of the three quartiles (1, 2, and 3) of the weighted average operating margin over the benchmarking period.

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Total TRS Operating Profit - Target TRS Operating Profit = Implied Rent Payment

Therefore, the target rent payment is derived using the interquartile range of operating margins established by the comparable companies, the projected sales, projected operating expenses, and the projected financial information for the TRS returned negative profit during the lease period ending December 2021. With that negative profit, the implied rent for the year ending December 2021 would be negative. Thus, of the implied negative rent payment attributable to the negative operating margin, the estimated rent payment was capped at $0 for the period ending December 2021. The rent payments for the periods ending December 2022 and December 2023 were set so that the TRS will achieve a net present value (NPV) of operating margin that is within the interquartile range of the independent companies' weighted average operating margins for the full three-year lease period.

Table 4 provides the derivation of the implied rent payments at the upper quartile, median, and lower quartile level of results for the three-year period with year-ends of December 2021, December 2022, and December 2023.

As presented in Table 4, the target operating profit for the TRS for each lease period was calculated as the revenue [A] multiplied by lower quartile, median, and upper quartile operating margin [C]. To calculate the implied rent payment [E], the target operating profit [D] was subtracted from the total TRS operating profit [B]. Given a lower bound of $0 for implied rent payments, the resulting implied rent payment for the lease period ending December 2021 is $0 [F], with

Table 5. Projected NPV of Operating Margin for TRS

Line Item	Variable	Projected Financial Information		
		Lease Period Ending		
		Dec. 2021	Dec. 2022	Dec. 2023
Revenue	[A]	$8,250,600	$12,100,000	$14,070,100
Partial period factor		1	1	1
Present value period		0.5	1.5	2.5
PV factor		0.95	0.86	0.78
Range of Adjusted Rent Payment (NPV Basis)				
Lower quartile		$0	$1,132,738	$1,766,472
Median	[G] = [NPV of F @ 11.8%]	$0	$768,532	$1,397,658
Upper quartile		$0	$448,030	$1,073,102
Revenue (NPV basis)	[H] = [NPV of A @ 11.8%]	$7,856,580	$10,447,909	$11,016,336
Operating Profit After Adjusted Rent Payment (NPV Basis)				
Lower quartile		-$361,853	$379,160	$363,863
Median	[I] = [NPV of (B-F) @ 11.8%]	-$361,853	$743,367	$732,677
Upper quartile		-$361,853	$1,063,869	$1,057,233
Adjusted OM (NPV Basis)				
Lower quartile		1.3%		
Median	[J] = [Sum (I over full lease period)/ Sum (H over full lease period)]	3.8%		
Upper quartile		6.0%		

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Table 6. NPV of Adjusted Rent Payments Versus Unadjusted Rent Payments

Year	Implied Range of Lease Payments (NPV)			Implied Lease Payments (Unadjusted)		
	Comparable Profits Method					
	Low	Median	High	Low	Median	High
2021	-$833,247	-$660,403	-$463,988	$0	$0	$0
2022	$885,0264	$1,114,878	$1,376,076	$448,030	$768,532	$1,132,738
2023	$1,469,354	$1,711,714	$1,987,122	$1,073,102	$1,397,658	$1,766,472
Total rent	$1,521,131	$2,166,189	$2,899,210	$1,521,131	$2,166,189	$2,899,210

additional adjustments performed for lease periods ending December 2022 and December 2023, to ensure that the TRS achieves a NPV of operating margin that is within the interquartile range of operating margins established by the comparable companies over the lease period.

To demonstrate that the range of adjusted rent payments are set to achieve a NPV operating margin that is within the interquartile range of the independent companies' weighted average interquartile range of operating margins for the full three-year lease period, the projected NPV operating margin earned by the TRS is calculated in Table 5.

Table 5 uses the range of adjusted implied rent payments on a NPV basis to calculate the TRS's expected operating profit after making the implied rent payments. To calculate the TRS's NPV OM over the three-year period, the TRS's NPV operating profit after making the rent payments is divided by the NPV revenue over the three-year period based on the implied rent payments at the lower quartile, median, and upper quartile. The resulting range is 1.3 percent to 6 percent with a median of 3.8 percent, which aligns with the interquartile range of independent companies' weighted average operating margin.

Therefore, in this case, it was possible for the REIT to defer requiring the TRS to make any rent payments during the first year of the lease period. The rent payments for the subsequent years would be set so that the TRS would still achieve the same level of profitability over the lease period as it would have if it had made rent payments in the first year of the lease period.

Table 6 illustrates that the NPV of adjusted rent payments is the same as the rent payments when the TRS would have been required to make rent payments in the first year of the lease period.

Therefore, in this case, the REIT may defer requiring rent from the TRS for the first year of the lease and still achieve the same return by requiring additional rent in subsequent years to cover for the lost rental income during the first year.

IV. What REITs Can Do

The U.S. economy is still experiencing significant economic uncertainty stemming from the COVID-19 pandemic. Thus, REITs and their TRSs may continue to face these economic uncertainties in their day-to-day operations. REITs and TRSs operating in the hospitality and healthcare industries were significantly affected as occupancy rates plummeted during 2020. The return to normalcy is well under way as vaccinations have become widely available in the United States and many travel and stay-at-home restrictions that were the norm in 2020 have been lifted. However, it is unlikely that operations will return to normal status as rapidly. Therefore, with this level of uncertainty, REITs and TRSs should continue to evaluate lease structures and apply arm's-length principles to determine rent payments. Best practices for REITs and TRSs include the following.

- *Reducing lease term length*: Given the level of economic uncertainty, REITs and TRSs would be better off entering into shorter leases, allowing them to reset rents more quickly and align them more closely to the prevailing market conditions. It is expected that with the availability of the COVID-19 vaccine and as more data are collected

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regarding to the efficacy of these vaccines, the economy will return to a steady-state level. Also, many other operators are authorizing short-term lease extensions, allowing them to continue with prevailing terms until the market stabilizes and they can enter into longer leases. However, under the income tax regulations, changes to how percentage rents are determined during the term of a lease (including renewal periods) may lead to the risk that one views rents as income or profits based, which raises a REIT qualification concern. Thus, one must consider how short a lease with a TRS can be.

- *Modeling*: The prevailing economic uncertainty also presents an opportunity for REITs and TRSs to model multiple scenarios, including downside and upside deviations from the norm. This allows REITs and TRSs to stress-test the potential effects of both revenue and income declines or growth, helping them to make better informed decisions on how to structure their leases.
- *Benchmarking analysis*: Lease structuring depends heavily on benchmarking to determine appropriate level of returns for the TRS. Thus, REITs and TRSs would benefit from updating benchmarking to assess the most reasonable returns for the TRS based on prevailing industry and market conditions.
- *Documentation*: Documentation is a critical component to help support the position taken by the REITs and TRSs related to the lease structure. Although the IRS has not provided any official guidance on how taxpayers must adjust related-party pricing in light of COVID-19, the OECD released guidance on December 18, 2020,[18] focusing on how the arm's-length principle and the OECD transfer pricing guidelines apply to issues that could arise or be exacerbated by the pandemic. In this guidance, the OECD emphasized that taxpayers must contemporaneously document how the pandemic has affected their operations. Thus, REITs and TRSs should focus on documentation, including showing how occupancy rates, revenues, and costs have changed during the pandemic.[19] ■

[18] OECD, "Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic" (Dec. 18, 2020).

[19] The information contained in this article is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

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