

Summary Comparison of Internal Lease Preferred Stock (ILPS) Financing to REIT Spinoff

REIT Spinoff

Corporate group's properties in a property subsidiary are leased to Operating Subsidiary at fair market value (FMV) rent. Property Subsidiary is spun off to Parent's shareholders, qualifies and operates as a REIT, trades publicly, and is separately managed.

Financial Statement Effect

- Earnings charge equal to market rents, straight-lined over lease term (if classified as Type B lease under FASB Lease Accounting Proposal) or front-end-loaded (if classified as Type A under FASB Proposal).
- Imputed balance sheet liability equal to present value of lease payments (whether lease is Type A or Type B).
- Even without a spinoff, these financial statement effects would follow where Group contributed its properties to a partnership controlled by a REIT (UPREIT structure).

Economic Effect

- Upon spin-off combined value of Parent shares and REIT shares exceed those of pre-spin-off Parent shares alone.
- Going forward, higher occupancy costs from FMV rents paid to REIT--front-end-loaded in the case of Type A leases—suppresses Group's earnings.
- FMV rent generally increases over time.
- Net effect: Front-end bump in stock price is at the expense of future earnings of the Consolidated Group.

ILPS Financing

Property Subsidiary (Issuer) leases properties to Operating Subsidiary. Both remain consolidated subsidiaries of Parent, which guarantees Lease. Issuer issues nonparticipating preferred stock (ILPS) equal to 70% of property FMV. ILPS pays market-rate dividend, resetting every five years per an index. Rents from Operating Subsidiary to Issuer, set to maintain a minimum coverage ratio for payment of dividends, reset whenever the dividend rate resets.

- Internal Rents between consolidated subsidiaries are eliminated in consolidation.
- No imputed liability under FASB Proposal.
- No imputed earnings charge under FASB Proposal.
- ILPS dividends are an *allocation of*—not a charge against—Net Earnings of the Consolidated Group, reported after the Net Earnings line as, "Net earnings attributable to non-controlling interests."
- Immediate cash infusion equal to 70% of net FMV of properties is available to for expansion, diversification, technology, etc.
- FMV rent expense is replaced by ILPS dividends which, besides not being a charge against Group earnings, reflect Group's cost of capital at the credit rating of its Parent (or other guarantor) rather than a market average cost of capital embedded in market rents.



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Tax Treatment to Investors

- Ideally, spin-off is tax-free.
- Future dividends often taxable as ordinary income due to typical low basis of properties spun off.
- REIT dividends do not qualify for 70% dividends-received deduction normally available to corporate investors, and are not “qualified dividends” eligible for capital gains rates in the hands of individual investors.
- Stock issuance is tax-free.
- Dividends are eligible for dividends-received deduction where the ILPS investor is a corporation, and for capital gains rates where investor is an individual.

Management Control

- REIT is separately managed.
- Remaining control of Parent over properties is whatever can be negotiated in the lease, factoring in REIT IPO underwriting and marketing concerns.
- Controls beyond those typically available to a full-building tenant may be rejected by underwriter as non-market and detrimental to REIT value.
- ILPS is nonvoting preferred stock.
- Management of Issuer *remains* management of the Consolidated Group.
- Future sale of building example: Under ILPS Parent controls sale decision subject only to partial redemption of preferred stock from sale proceeds, whereas in a REIT lease probably the most control obtainable would be a Right of First Offer in favor of Operating Subsidiary following REIT’s decision to sell.

Complexity

- A REIT spin-off is complex from a tax standpoint, typically involving uncertain tax positions. The complexity involved is highlighted by the IRS’s September 14, 2015 announcement that it will no longer issue advance rulings on the tax-free status of such reorganizations.
- REIT IPO involves substantial securities and issuance cost and is time-consuming.
- As a separate public company, the REIT has its own set of ongoing SEC reporting responsibilities.
- REITs are subject to detailed tax rules regarding distribution and monitoring of stock ownership, as well as significant restrictions on composition of the REIT’s income and assets.
- If ILPS issue is non-publicly traded, SEC registration can be avoided.
- Issuance costs of preferred stock by an investment-grade issuer are low; e.g., a typical underwriting spread is 1%. And while ILPS is patented, royalty will be priced to keep overall financing cost advantageous.
- Assuming a private placement, incremental financial reporting consists essentially of what is built into the preferred stock indenture.
- Limitations on assets and activities of the Issuer are a function of the preferred stock indenture, not the complex tax-based restrictions that apply to a REIT.



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