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A Common Question from Hotel REITs: Should the TRS Lease Be Amended during Tough Times?

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Bracing for a continuing economic downturn, members of the hotel industry are considering a number of actions, including asking for relief from lessors. What if the lessor is a real estate investment trust ("REIT")? The answer includes a dose of caution.

REITs are allowed to organize taxable REIT subsidiaries ("TRSs") that can engage in activities that would otherwise raise REIT qualification concerns. Additionally, notwithstanding that rents from related tenants are treated as nonqualifying income, a REIT can lease its hotels to a related TRS if the hotels are operated by "eligible independent contractors" on behalf of the TRS. This hotel lease arrangement between a REIT and its TRS is commonly referred to as the qualified lodging exception and became effective on January 1, 2001. Since then, many REITs have been organized to use this structure to own and operate—through third party managers—hotel properties.

While the statute allows this qualified lodging exception, the basic REIT qualification considerations still apply. That is, the arrangement must be considered a true lease for U.S. federal income tax purposes and not a joint venture or management contract, and the determination of payments must not depend in whole or in part on the income or profits of the TRS from the hotel property. Because a TRS is often majority-owned by the REIT and, as a C corporation, subject to a corporate level tax on its taxable income, how to establish fair market rental value is challenging. If rents are set too high, the substance

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of the arrangement may be questioned; if rents are set too low, significant income taxes may be realized. To make the matter even more complicated, there are few triple net (NNN) leases between unrelated parties involving hotel properties in the United States. Leases between unrelated parties for special-purpose properties—such as skiing, gaming, skilled nursing, or assisted living— exist; however, those leases often include terms that are materially different from leases between hotel REITs and their TRSs. The differences may include duration, financial covenants, and capitalization, which render those leases not perfect comparables.

When analyzing fair market rental value, transfer pricing and valuation professionals consider the functions to be performed by the TRS (e.g., passively engaging a hotel manager) and identify companies that perform similar functions. They then determine the profitability of these comparables and advise on rent structures intended to achieve similar profitability based on financial projections prepared by the hotel REITs. Because the hotel industry is cyclical and sensitive to business and personal discretionary spending levels, many hotel REITs employ a combination of fixed and percentage rents to address room rate fluctuation. Despite careful modeling of lease payments to create a reasonable expectation of profits in a TRS lessee, the TRS may still face operating difficulties in challenging economic conditions. For example, 9-11 and the 2008 financial crisis are two events that caused many hotel TRSs to sustain significant operating losses because the effects of those unfortunate events were not foreseeable and not included in financial projections. It took many years for hotel TRSs to burn through their operating losses and become tax-paying entities.

With the current coronavirus (COVID-19) pandemic—which has already led to a significant reduction in travel (business or pleasure) and temporary closures (voluntarily or involuntarily)—many hotel TRSs are likely facing similar operational challenges in the near term. Thus, a threshold question: Is it permissible for a hotel REIT and its TRS to modify an existing lease during its term?

The principal concern in this situation is whether such a renegotiation with a controlled tenant makes the lease appear to be based on the income or profits of the tenant (i.e., hotel operations), or makes the lease appear more akin to a management agreement than a bona fide lease. On the other hand, considering that lease modifications or cancellations are not uncommon between unrelated parties during adverse economic periods, taking no action may similarly raise questions. That is, if the TRS were unrelated, would it have continued to incur significant losses with no hope of retaining any profits after rent payments? Would it have not considered giving the property back to the landlord? For example, one REIT with non-lodging properties NNN leased to operating tenants disclosed in its annual filing with the SEC "[c]ertain of our tenants continued to experience operating challenges and limited ability to obtain working capital from lenders or capital partners and defaulted on their leases." The same REIT disclosed further "in an effort to provide relief to our tenant and diversify our tenant concentration, we provided rent forbearance for selected properties." Many health care and retail property owners have also amended leases with their third party tenants, including rent forbearance and reduction, following financial difficulties. Accordingly, the answer to the question should be that in limited circumstances it may be appropriate for a hotel REIT to evaluate the needs to amend a lease with its TRS (including rent concession) and to do so only after careful consideration because the REIT may get only one chance to make it right.

Considering many hotel REITs are still evaluating various cost-cutting plans in response to the coronavirus pandemic and do not yet have a clear picture of its effect at this time, now may be too soon to amend leases and reset the rent terms. Rather, it may be more appropriate to enter into some forbearance agreements for now and wait until there are better assessments and projections on a longer-term basis.

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