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

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by Dene Dobensky, David Lee, Leesa Overmann, and Sharon Liu, KPMG*

The effects of the coronavirus on the economy and different businesses have been widely reported and caused rent concession requests from tenants. What if the landlord is a real estate investment trust (“REIT”) that leases property to a related tenant? 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. A REIT can lease its qualified healthcare property (“QHCP”) to a related TRS if the property is operated by an “eligible independent contractor” for the TRS, even though rents from related tenants are treated as nonqualifying income. This healthcare lease arrangement between a REIT and its TRS is commonly referred to as the “RIDEA structure” and became effective for tax years beginning after July 30, 2008. Since then, many REITs have been organized to use this structure to own and operate—through third party managers—senior housing properties meeting the definition of a QHCP.

While the statute allows this RIDEA structure, 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 QHCP. Because a TRS is often majority owned

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* *Dene Dobensky is a business tax services partner in New York City. David Lee is a member of the REIT Services team and a partner in the Passthroughs group of Washington National Tax. Leesa Overmann is a business tax services partner in Dallas. Sharon Liu is a principal in the Economic and Valuation Services practice in Chicago.*

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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 of the arrangement may be questioned; if rents are set too low, significant income taxes may be realized. Note that prior to the RIDEA structure, healthcare REITs triple-net ("NNN") leased QHCPs to unrelated operator tenants, and even today, there are healthcare REITs that continue to rely on the NNN-lease arrangement for their senior housing properties. However, those leases often include terms that are materially different from leases to be entered into between a REIT and its TRS. 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 an operator) 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 healthcare REITs. Despite careful modeling of lease payments to create a reasonable expectation of profits in a TRS lessee, the TRS may still face operating difficulties during challenging economic conditions. The coronavirus reportedly has already had a significant impact on operations of senior housing properties (including unanticipated costs associated with personal protective equipment and more frequent cleaning and disinfecting, as well as no new move-ins).

Thus, the question: Is it permissible for a healthcare 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., healthcare 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 considered giving the property back to the landlord?

For example, many healthcare and retail property owners amended leases with their third party tenants, including rent forbearance and reduction, following financial difficulties in the past. Also, one publicly traded healthcare REIT disclosed in March 2020 that it established a rent deferral program, under which its senior housing tenant operators can defer "25% of their April 2020 payment obligation until the earlier of October 1, 2020 or receipt of government assistance."[1] Another publicly traded healthcare REIT that leases senior housing properties to third party tenant-operators (in addition to its TRSs) noted in early April "lower occupancy and higher expenses will reduce EBITDAR coverages," and "in limited circumstances [it] may defer certain operator rent payments."[2] Finally, another publicly traded healthcare REIT disclosed in its quarterly filing that it has agreed to rent deferral for certain operators

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[1] Press release: https://www.sec.gov/ix?doc=/Archives/edgar/data/740260/000110465920040020/tm2013986-1_8k.htm.

[2] Press release: https://www.sec.gov/Archives/edgar/data/765880/000110465920043985/tm2015178d1_ex99-2.htm.

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"[i]n recognition of the unique conditions affecting our operators."[3] Accordingly, the answer to the question should be: In limited circumstances, it may be appropriate for a healthcare REIT to evaluate the need to provide a rent deferral in the short term to its TRS tenant and, after careful consideration, possibly amend the lease.

It is important to recognize that the impacts of the coronavirus pandemic on a senior housing property are drastically different from those on a hotel property, which can also be leased by a REIT to its related TRS. For example, after a senior housing property is stabilized and a high occupancy is maintained, a TRS tenant continues collecting resident fees; however, in response to the pandemic and to protect its residents, the TRS tenant (through the operator) incurs higher operating costs. In comparison, a hotel property may be ordered to close temporarily by a local government or experience a significant decline in occupancy due to fear and travel restrictions. This means that the approach taken by a healthcare REIT regarding a lease of a senior housing property will not be the same as the approach concerning a lease of a hotel property.

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[3] 10-Q: https://www.sec.gov/ix?doc=/Archives/edgar/data/887905/000155837020004970/ltc-20200504x10q.htm.

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