Unlocking Value Through REIT Spin-Offs

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Real estate investment trust (REIT) spin-offs provide a means for companies to unlock the value of their real estate. Due to current economic conditions, more companies in more business sectors are considering separating their real estate from their operating businesses to take advantage of the favorable economic climate that allows REITs to raise capital at a relatively low cost.

Spun-off REITs engage in ongoing lease and contractual relationships with the legacy operating companies. While one tax reform proposal contemplated barring REITs from the tax-free spin-off rules, companies continue to recognize the strategic nontax business advantages of separating their real estate and operations into autonomous enterprises that appeal to different and broader investor bases and lower the cost of their capital.

Strategic Benefits of REIT Spin-Offs

REIT spin-offs fundamentally provide a means for companies to unlock the value of their real estate, which the market often significantly undervalues when it is held within an operating company. The general business rationales for spin-offs hold true in the REIT context. Both the existing company and the newly formed independent REIT can focus on their core businesses after a spin-off. The newly formed REIT, for example, can pursue investments in real estate, infrastructure and networks. The operating company can focus on running its operating business and providing services to customers. Real estate investments often have a different optimal capital structure than more active operating businesses. Thus, a company can spin off its qualifying assets into a REIT and, as a result, shed debt that the REIT, with its steady rental income, can better absorb. Additionally, the REIT becomes a new and distinct opportunity for investors, including those more interested in a "pure play" real estate company, rather than a company comprised of both operations and real estate assets. While some commentators have focused exclusively on the enhanced tax efficiencies inherent in the aforementioned structure, many corporations have strong nontax reasons to pursue the REIT spin-off option, such as appealing to a different and broader investor base and lowering their cost of capital.

Windstream Receives Favorable IRS Private Letter Ruling

Windstream Holdings, a telecommunications corporation, recently announced it intends to spin off its copper and fiber network into a REIT. Many other corporations that previously held significant real estate assets also have chosen tax-free REIT spin-offs. In July 2014, Windstream reported that it had received a favorable private letter ruling in which the Internal Revenue Service confirmed that (1) Windstream's fiber and copper networks are qualifying REIT assets under the Internal Revenue Code, and (2) the spin-off of those assets in a newly formed REIT (independent of Windstream) would qualify as tax-free. The REIT could then lease the fiber and copper networks back to Windstream, the income from which would largely pass through to the REIT's investors without corporate-level tax.

The Complexity of the REIT Regime

Companies also must weigh the complexity of the REIT rules, which require sophisticated planning, against the anticipated benefits. A REIT must invest at least 75 percent of its assets in real estate and cash, derive at least 75 percent of its gross income from rents from real property or mortgage interest, and pay out at least 90 percent of its taxable income to shareholders, among many other requirements. Additionally, both the distributing corporation and the spun-off REIT must have been engaged in the active conduct of a trade or business for five years. In other words, the REIT rules must dovetail with the requirements for spin-offs, including having a valid corporate business purpose for the transaction, e.g., enabling a corporation in an active business to spin off its real estate assets and focus on its core operating business, while providing a real estate-only opportunity subject to a sophisticated tax regime to investors.

REIT Spin-Offs and Tax Revenue

REITs generally are not subject to corporate-level tax, and thus provide a tax-efficient method of real estate investment. Ignored by some critics, however, are the ways in which the elimination of corporate-level tax is, in part, offset by increases in revenue at the Treasury level. First, because a REIT must distribute at least 90 percent of its taxable income (and most REITs distribute 100 percent), REIT conversions permanently increase individual ordinary tax revenues. This requirement precludes investors from deferring taxation while earnings remain at the corporate level. Furthermore, distributions made out of a REIT's earnings and profits are taxed at the maximum 39.6 percent ordinary income rate, not at the lower maximum 20 percent capital gains rate to which corporate dividends are normally subject for individual/noncorporate shareholders. REIT conversions also increase tax revenues because a converting REIT must distribute all of its accumulated earnings and profits in a taxable dividend. Without a REIT election, such earnings might never be distributed. Finally, and most importantly, REIT spin-offs can create real value for shareholders for the reasons discussed above. That increased value is the ultimate goal of REIT spin-offs and will generate long-term revenue for the Treasury.

Conclusion

In certain cases, a REIT spin-off is an attractive option for corporations with significant real estate assets. It has significant potential to improve a company's financial position, enable management to focus on its company's key operations, and provide real estate-oriented investors with new opportunities.