

Transfer Pricing for REITs

June 13, 2018

Susan Fickling-Munge, Managing Director, Duff & Phelps

Ryan Lange, Director, Duff & Phelps

Leda Zhuang, Director, Duff & Phelps

DUFF & PHELPS

Duff & Phelps is the global advisor that protects, restores and maximizes value for clients in the areas of valuation, corporate finance, investigations, disputes, cyber security, compliance and regulatory matters, transfer pricing and other governance-related issues. We work with clients across diverse sectors, mitigating risk to assets, operations and people.

MORE THAN
15,000
ENGAGEMENTS
PERFORMED IN
2017

6,500
CLIENTS
INCLUDING
OVER
50% OF THE
S&P 500



3,500+
TOTAL
PROFESSIONALS
GLOBALLY

THE
AMERICAS
2,000+
PROFESSIONALS

EUROPE AND
MIDDLE EAST
1000+
PROFESSIONALS

ASIA
PACIFIC
500+
PROFESSIONALS

Real Estate Advisory Group Overview

REAL ESTATE VALUATION & CONSULTING

- MAI Appraisals
- Financial and Tax Reporting Valuations
- REIT & Real Estate Operating Company Valuations
- Debt Valuation
- Financing Appraisals
- Transfer Pricing
- Portfolio Valuation – Positive Assurance
- Cost Segregation and Construction Tax Planning



REAL ESTATE ADVISORY SERVICES

- Operational & Process Improvements
- Technical Advisory/Property Condition Reports
- Market Feasibility Studies
- Loan Services
- Debt Advisory
- Construction Project and Program Management



REAL ESTATE TRANSACTION DUE DILIGENCE

- Lease Abstraction and Analysis
- Site / Market Due Diligence
- Estoppels' Certificate Preparation & Review
- NOI Trend Analysis
- Tenant Reimbursement Analysis
- Argus & Dyna Modeling / Auditing
- REIT Income Analysis
- Transfer Pricing



REAL ESTATE INVESTMENT BANKING

- Equity and Debt Placement Services
- Sell Side Advisory Services
- Buy Side Consulting Services
- Real Estate Transaction Opinions
- Solvency Opinions
- Fairness Opinions
- Independent Fiduciary Opinions



Transfer Pricing Professionals

Duff & Phelps
serves

5,000+

clients globally



Globally integrated team across the Americas, Europe and Asia-Pacific

Frequently recognized among world's leading transfer pricing advisors

Hold leadership positions in tax and transfer pricing industry associations

Advise governing bodies on transfer pricing issues and best practices

Serve as expert witnesses in major transfer pricing litigation, arbitration and controversy cases

Author substantive books, periodicals, and articles on transfer pricing and tax valuation matters

Transfer Pricing Services

Duff & Phelps provides technically rigorous and practical transfer pricing services throughout the entire transfer pricing lifecycle for a multinational company – from design and documentation to defense of global transfer pricing positions

DESIGN

- Understand objectives
- Review of current state
- Incentive planning
- Location selection
- Economic modeling
- Implementation assistance
- Internal policy manuals (e.g. Treasury Manuals)
- IT, operational and transfer pricing systems design

DOCUMENT

- Global Master file documentation
- Local file documentation
- CbC reporting
- CbC risk assessment
- Filing of CbC reports and documentation
- Transfer pricing policy reports
- Tax file memorandums
- Regulatory compliance documentation
- Legal agreement review

DEFENSE

- Risk reviews and gap analyses
- Transfer pricing audit readiness reviews
- Strategic transfer pricing audit management
- Expert witness testimony
- MAP negotiation
- Assistance in arbitration and State Aid proceedings
- Negotiation and conclusion of unilateral, bilateral and multilateral APAs

Meet the Speakers



Susan Fickling-Munge

Managing Director

**Duff & Phelps
Transfer Pricing**



Ryan Lange

Director

**Duff & Phelps
Transfer Pricing**



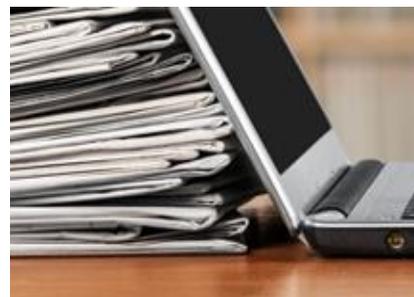
Leda Zhuang

Director

**Duff & Phelps
Transfer Pricing**

Contents

1. REIT Transfer Pricing: Overview
2. REIT Transfer Pricing: REIT / TRS Transactions
3. REIT Transfer Pricing: Strategic Services



Section 1

REIT Transfer Pricing

Overview

Real Estate Transfer Pricing

Overview

- The real estate sector is highly-leveraged, with significant debt financing required for property acquisition, development / construction, etc.
- This sector observes strong business cycles impacted by the property development period, the macroeconomic situation (especially the federal interest rate), location choices, etc.
- The real estate sector falls under various regulatory framework (tax and related) as described below:
 - Special considerations are provided for REIT / TRS transactions under IRC Sections 856 and Section 857.
 - U.S. transfer pricing regulations specified under IRC Section 482, which are usually relied upon to analyzed the pricing of related party transactions.
 - To the extent that intercompany transactions involve a non-U.S. country, OECD transfer pricing rules and local country transfer pricing requirements should be considered.
 - Other regulatory requirements, e.g., SEC requirements or other regulatory compliance for investors.

Real Estate Industry Experience

INDUSTRIES AND PROPERTIES COVERED

- Hotel
- Residential
- Healthcare
- Educational
- Industrial Warehousing
- Self-Storage
- Shopping Centers
- Office
- Senior-Living
- Data Center / Server Farm
- Midstream / Oil and Gas

TRANSACTIONS ADDRESSED

- Intercompany financing related to debt capacity and interest rate determination
- Property acquisition and disposition
- Property development and construction management
- Asset management
- Loan servicing
- Real Estate Investment Trust (“REIT”) / Taxable REIT subsidiary (“TRS”) transactions
- Lease payments
- Interest payments
- Corporate services and employee sharing
- Customary services
- Non-customary services

Recent Real Estate Industry Experience

REAL ESTATE INVESTMENT TRUST

Performed a comprehensive analysis of lease rates between a REIT and its related TRS in anticipation of public offering. Scenarios were performed at varying levels of anticipated hotel profitability to inform the valuation.

INTERCOMPANY FINANCING

Reviewed debt capacity and associated interest rates for intercompany loans between related hotel owners and operators.

HOTEL PORTFOLIO

Prepared analyses of over 40 properties held by a multinational hotel owner in various REIT/TRS structures. Analysis included various scenarios around lease payments and leverage ratios.

PRIVATE EQUITY

Analyzed the commercial reasonableness of fees charged between related parties for property management services, property development services, and hotel management services in conjunction with anticipated audit inquiries from portfolio companies.

FAIRNESS OPINION

Reviewed and provided assistance to a Company's board of directors in regards to an acquisition of a target real estate operator which is a leader in U.S. workforce accommodations offerings to a variety of clients in the following industries: oil, gas, mining, alternative energy, military, disasters and special events.

Recent Real Estate Industry Experience

GLOBAL PROFIT SPLIT FOR ASSET MANAGER

Performed a global transfer pricing planning analysis for multinational real estate asset manager, whereby we analyzed and modeled the relative value associated with each component of the asset management value chain.

PROPERTY AND CONSTRUCTION MANAGEMENT FEE BENCHMARKING

Performed two benchmarking analyses, one for each type of service, to determine arm's-length fees for related-party provision of these services for SEC compliance and investor conflict of interest purposes.

DEBT SERVICING FEE BENCHMARKING

Performed a compliance analysis to test arm's-length fees for debt servicing and related functions performed by a real estate servicing company to several related-party real estate investment funds.

BENCHMARKING FOR VARIOUS SERVICES FEES AMONG AFFILIATED ENTITIES

Determined services fees to be charged for various services, including acquisition services, property management services, disposition services, and other ancillary services specific to industries (e.g., hotel operator services for hotels/lodges, landscaping services for apartment/senior living, packaging/trucking for warehouses, etc.)

Section 2

REIT Transfer Pricing

REIT / TRS Transactions

Why is Transfer Pricing Needed for REITs?

- The REIT Modernization Act (RMA), effective January 2, 2001, allows REITs to offer many income-producing services associated with their properties, which resulted in intercompany services transactions in which employees of one affiliate (a REIT or TRS) undertake activities on behalf of another affiliate (the TRS or the REIT).
 - REITs do not pay corporate income tax but have strict rules including limitations on what functions they may perform and what revenues they can earn. Given these limitations, REITs often rely upon a taxable REIT subsidiary (“TRS”) to perform restricted functions and earn restricted revenues
 - TRSs have fewer restrictions but are subject to federal income taxes
 - The anti-abuse provisions subject certain payments to transfer pricing rules, including a 100% penalty for the following intercompany items:
 - » Redetermined rents;
 - » Redetermined deductions;
 - » Excess interest; and
 - » Redetermined TRS service income.

Why is Transfer Pricing Needed for REITs?

- Although a safe harbor is provided to avoid the 100 percent penalty (150 percent of costs for the TRS services), performing a thorough transfer pricing analysis often provides a more satisfactory outcome in line with the operational and financial objectives of many REITs.

	Key	Pricing Alternatives for TRS		
		Non-Arm's Length (TRS's Profit Margin based Cost+ 3%)	Safe Harbor (150% of Direct Cost)	Arm's Length (TRS's Profit Margin based Cost+ 10%)
TRS's Service Revenue from REIT	(a)	\$5,150,000	\$6,000,000	\$5,500,000
TRS's Direct Cost	(b)	\$4,000,000	\$4,000,000	\$4,000,000
TRS's Indirect Cost	(c)	\$1,000,000	\$1,000,000	\$1,000,000
TRS's Taxable Income	(d) = (a) - (b) - (c)	\$150,000	\$1,000,000	\$500,000
TRS's Tax Liability	(e) = (d) x 21%	\$31,500	\$210,000	\$105,000
REIT's Re-determined Rent [1]	(f)	\$350,000	N/A	N/A
REIT's Tax Liability [2]	(g) = (f)	\$350,000	N/A	N/A
TRS's Adjusted Taxable Income	(h) = [(b) + (c)] x 10%	\$500,000	N/A	N/A
TRS's Adjusted Tax Liability	(i) = (h) x 21%	\$105,000	N/A	N/A
Total Combined (TRS & REIT) Tax Liability	(j) = (g) + (i)	\$455,000	\$210,000	\$105,000

[1] The IRS re-determination of rent is based on a 10% arm's length markup rate. The Re-determined rent is calculated as $[(b) + (c)] \times 1.10 - (a)$ or $\$5,500,000 - \$5,150,000 = \$350,000$

[2] 100% tax penalty on re-determined rent

Relevant Code Sections for REIT Transfer Pricing

IRC Section 856

- Lease of healthcare properties to a TRS
- Rent based on gross revenues
- Comparable rent test for qualifying income for certain types of leases

IRC Section 857

- Imposes 100% excise tax on re-determined rents, re-determined deductions, excess interest and re-determined TRS service income.
- A REIT and its TRS can base allocations on “any reasonable method”

IRC Section 482

- Applicability of Section 482 when 100% excise tax is imposed is a matter of debate
- Is 100% excise tax the sole recourse available to the IRS?

Typical Transactions between REITs and TRS/Funds

Lease Payments

- Conventional Leases (e.g., healthcare and hotel leases)
- Non-Conventional Leases (e.g., retail, advertising space, common-areas, rooftops)

Financing

- Loans
- Financial Guarantees

TRS/REIT Services

- Property development and/or construction management;
- Corporate Services (or employee sharing)
- Property management
- Tenant insurance
- Mortgage loan origination and servicing
- Other non-customary services

Fund/REIT Services

- Asset management
- Investment management

Examples of REIT/TRS Transactions

Conventional Leases

- Typical for Hotel and Healthcare REITs where the TRS pays rent for the lease of the property
- Transfer Pricing considerations:
 - Reliability of projections
 - Method used to determine lease payments

Non-Conventional Leases

- Often relates to leases of retail areas, rooftops, advertising space, common areas, etc.
- Transfer Pricing considerations:
 - How is the leased area measured/defined?
 - How is the value of intangibles reflected in the lease payments?
 - Do these payments qualify as “comparable rent” specified in IRC § 856(d)(8)(A)(ii)?

Examples of REIT/TRS Transactions

Development Services and Construction Management

- Either a REIT or a TRS may perform these services.
- Transfer Pricing Considerations:
 - Structure of compensation (depends on facts and circumstances)
 - Volume adjustments
 - Risk allocation (and implications)

Non-Customary Services

- These are services that are NOT typically provided to tenants in buildings of similar class and geographic location
 - The REIT may or may not charge the tenants separately for these services
 - Service provided to tenants by a TRS (e.g., security, janitorial, maid services, parking services)
- Transfer Pricing Considerations:
 - Is the REIT owed compensation for providing the TRS access to its tenants?

Examples of REIT/TRS Transactions

Employee Sharing and Corporate Services

- Often observed in REITs that have TRSs, where the TRS uses REIT employees for its business or the REIT performs services on behalf of the TRS.
 - The TRS can enter into an employee cost sharing agreement with the REIT.
 - If the REIT performs any services on behalf of the TRS, charges should be made to the TRS in alignment with the benefits it receives.
 - » While a REIT cannot earn service income, Private Letter Rulings have allowed REITs to perform certain corporate services for the benefit of a TRS.
- Transfer Pricing Considerations:
 - Allocations in both the employee cost sharing arrangement and centralized corporate services scenarios should be allocated according to the rules laid out in 1.482-9.

Examples of REIT/Fund Transactions

Asset or Investment Management Services

- Fund / Asset managers often perform asset and investment management services for REITs and investors.
 - These services are often priced separately and pricing structures can vary (e.g., fixed fees, hourly rates and assets under management (AUM))
 - Other types of asset management and property management services are often observed between Funds and properties they invest in.
- Transfer Pricing Considerations:
 - Do the fees need to be arm's length? (tax vs. regulatory)
 - Management fee split analyses may be required.

Section 3

REIT Transfer Pricing

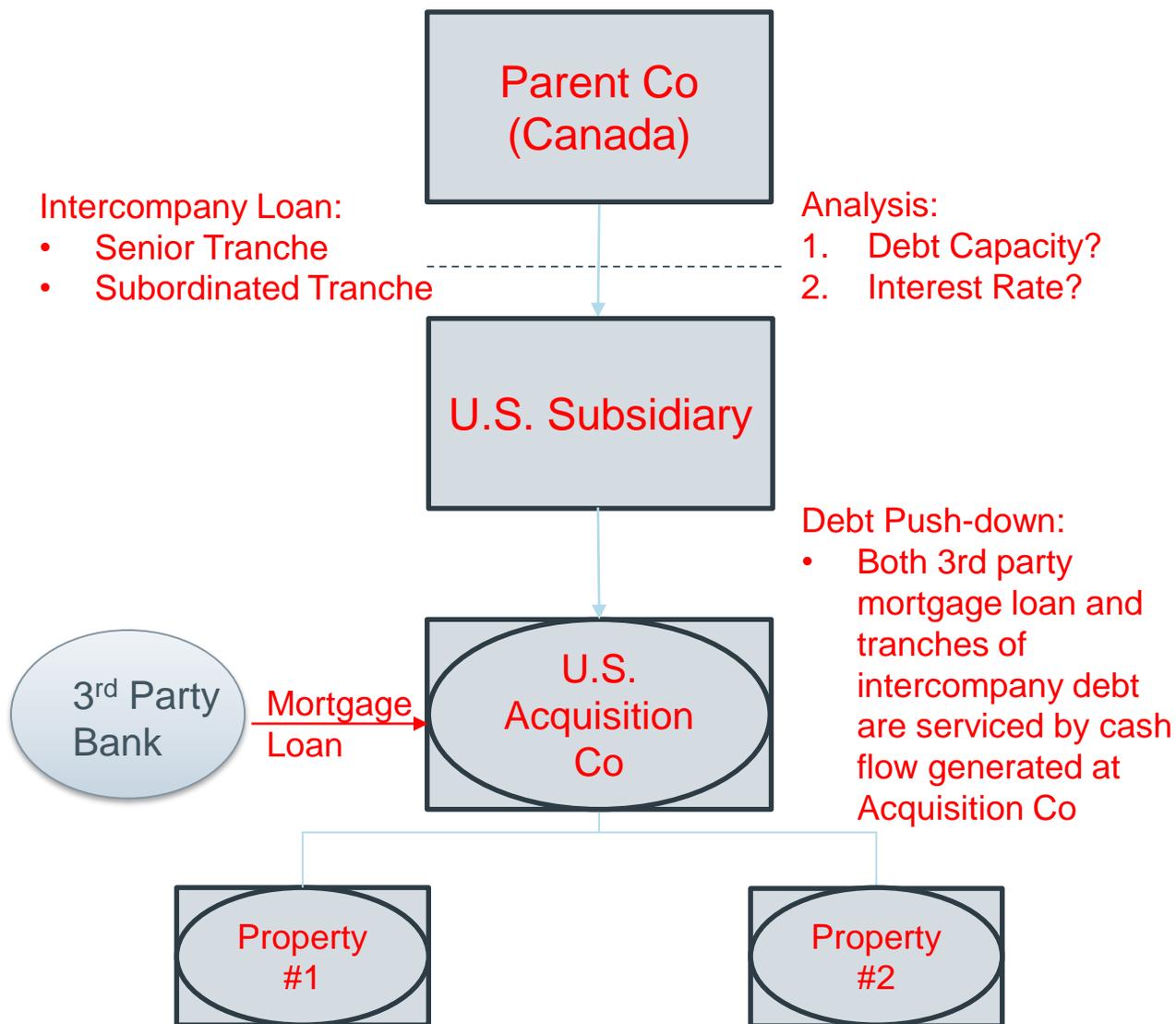
Strategic Services

Strategic Services

Financing Arrangement

- Real estate companies rely heavily on debt financing may utilize a debt structure that consists of senior mortgage debt, subordinated debt, or mezzanine debt, with increased risks based on each debt instrument's default probability.
- A transfer pricing review is necessary to support not only the interest rate of the debt instrument, but also the primary terms/conditions (e.g., seniority, subordination level, and nature of debt) between related parties.

Strategic Services – An Example of Debt Push-down Structure



Debt Structure at U.S. Acquisition Co:

- 3rd party mortgage debt
- Intercompany debt #1 – a senior tranche subordinated to mortgage loan
- Intercompany debt #2 – a deeply subordinated tranche or a mezzanine debt

Strategic Services

Converting to / from a REIT

- REITs have become more popular for businesses that have traditionally been reluctant to adopt such a structure (e.g., owners and operators of data centers and server farms).
- Whether converting to/from a REIT structure, transfer pricing matters should be addressed to optimize financial benefits and mitigate against restructuring risks.

How Duff & Phelps Can Help

RISK MANAGEMENT AND TAX OPTIMIZATION STRATEGIES

- Review financial results of various entities, with a focus on any losses or high margins resulted from pricing of related party transactions
 - Losses or very low margins in high-tax jurisdictions or taxable TRS could invite inquiries by the tax authorities
 - Very high margins in low-tax jurisdictions or tax-exempt entities may indicate tax optimization opportunities
- Review transfer prices for material transactions and prepare transfer pricing studies to support the pricing of such transactions

TAX CONTROVERSY SUPPORT SERVICES

- Respond to IRS information & data requests
- Advise based on requirements under the relevant regulations
 - U.S. IRC Sections 856, 857 or 482
 - OECD rules or other local country requirements
 - Responds to SEC or investor inquiries
- Negotiate settlements with IRS Field Exam teams
- Advise on IRS Appeals process

Questions?



Biographies

Susan Fickling-Munge

Managing Director, Valuation Advisory Services



Duff & Phelps, LLC
Chicago
+1 312 697 4647
Susan.Fickling-Munge@duffandphelps.com

Susan Fickling-Munge is a managing director in the Chicago office of Duff & Phelps. She is a member of the Transfer Pricing practice, leveraging more than 15 years of transfer pricing and valuation experience. Susan has worked closely with global companies in a vast range of industries, assisting them with transfer pricing planning, documentation and defense.

Susan has extensive experience in international and multistate tax planning projects, employing various transfer pricing techniques to help support her clients' tax strategies. She has also assisted clients on unilateral advance pricing agreements. She has helped to develop real options models and valuation techniques to support complex transfer pricing and tax structuring scenarios.

Before joining Duff & Phelps, Susan was a vice president of transfer pricing for Charles River Associates, a transfer pricing manager in the international tax division of Arthur Andersen LLP and a transfer pricing consultant at KPMG LLP.

Susan earned her MBA at the University of Chicago Booth School of Business and her BA from Scripps College. She also studied at the Universidad San Francisco de Quito in Quito, Ecuador, and is fluent in Spanish.

Ryan Lange

Director, Valuation Advisory Services



Duff & Phelps, LLC
Chicago
+1 312 697 4786
Ryan.Lange@duffandphelps.com

Ryan Lange is a director in Duff & Phelps' Chicago Transfer Pricing Practice, and advises clients' senior management on a variety of issues related to transfer pricing, economics and valuation. Specifically, Ryan leverages more than 12 years of experience to provide sound and practical economic advice to companies that range from Fortune 500 companies to start-up businesses in a broad range of industries – including consumer goods, education, medical products, pharmaceutical, e-commerce, automotive, telecommunications, financial services, real estate, software, energy, and industrial goods.

Throughout his career, Ryan has supported and managed large litigation support projects, prepared US, OECD and local country transfer pricing documentation, assisted in the design and preparation of economic planning and global policy projects, advised on intellectual property valuation issues, and analyzed complex transfer pricing issues in compliance and controversy contexts.

Ryan began his career in the Business Financial Services division of Merrill Lynch, and prior to joining Duff & Phelps was a Director for Ceteris. Ryan received a Bachelor of Business and Administration degree (summa cum laude) in Finance, Investment and Banking and a Bachelor of Business and Administration degree (summa cum laude) in Real Estate and Urban Economics, with a concentration in Risk Management, from the University of Wisconsin-Madison. Ryan also earned his Masters in Business Administration from the Kellstadt Graduate School of Business.

Ryan is active in the international tax community and holds a leadership position within the Chicago Tax Club, and has chaired the international tax committee for the past five years. He has also co-authored a number of articles for publications and speaks frequently on transfer pricing topics at conferences both domestically and internationally.

Leda Zhuang

Director, Valuation Advisory Services



Duff & Phelps, LLC
Atlanta
+1 678 916 2534
Leda.Zhuang@duffandphelps.com

Leda Zhuang joined Duff & Phelps in 2017 as a director in the Atlanta office and part of the Transfer Pricing practice. Leda has assisted numerous multinational firms to evaluate and address their intercompany pricing matters for purposes of documentation, business restructuring and tax planning. She led the economic analysis for various client engagements related to Advanced Pricing Agreement ("APA") negotiated, tax controversy and intangible property valuation. Leda has developed her expertise in a broad spectrum of industries, including real estate, financial services, telecom and technology, pharmaceutical and fashion products.

Prior to joining Duff & Phelps, Leda was a senior manager with Deloitte for over 10 years. She made significant contribution to establishing and strengthening the team's expertise in the areas of financial services transactions, real estate, telecom and technology. She also served as a core member of Deloitte's National Industry Programs for each of those specialty areas. During 2011-2012, Leda was on secondment to Deloitte's Shanghai office, where she advised multinational firms on transfer pricing arrangement related to their business operation in Asia.

Leda has a Ph.D. in Economics from the University of Colorado, Boulder, and a B.A. in Economics from Renmin University of China. She is also a CFA charter holder.

For more information about our global locations and services, please visit:
www.duffandphelps.com

About Duff & Phelps

Duff & Phelps is the global advisor that protects, restores and maximizes value for clients in the areas of valuation, corporate finance, investigations, disputes, cyber security, compliance and regulatory matters, and other governance-related issues. We work with clients across diverse sectors, mitigating risk to assets, operations and people. With Kroll, a division of Duff & Phelps since 2018, our firm has nearly 3,500 professionals in 28 countries around the world. For more information, visit www.duffandphelps.com.

M&A advisory, capital raising and secondary market advisory services in the United States are provided by Duff & Phelps Securities, LLC. Member FINRA/SIPC. Pagemill Partners is a Division of Duff & Phelps Securities, LLC. M&A advisory, capital raising and secondary market advisory services in the United Kingdom are provided by Duff & Phelps Securities Ltd. (DPSL), which is authorized and regulated by the Financial Conduct Authority. M&A advisory and capital raising services in Germany are provided by Duff & Phelps GmbH, which is a Tied Agent of DPSL. Valuation Advisory Services in India are provided by Duff & Phelps India Private Limited under a category 1 merchant banker license issued by the Securities and Exchange Board of India.