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BACK TO THE FUTURE FOR REAL ESTATE IN NEW TAX AND ACCOUNTING RULES

by Dale Anne Reiss

A stream of events over the last 12 months from passage of the Sarbanes-Oxley Act to President Bush's tax cut package to a wave of recently enacted accounting rules has hit the industry and corporate America. So much is new that it will take some time for real estate companies - and companies generally - to sort out all the ramifications for their businesses and the economy. This much is clear: governance, accounting and tax issues are front and center for the foreseeable future, and real estate companies will have to give them close attention, for they could have far-reaching effects on companies' financial statements and operations. In plain terms, the risk management profile for companies in the real estate sector just became much tougher.

Here are some of the changes that are particularly important for the real estate sector.

REITs

Real estate investment trusts may represent only 10 percent of the entire commercial real estate universe but they are a tremendously important and visible minority within the sector. The cumulative effect of Sarbanes Oxley, new tax reforms and various accounting changes, has hit REITs particularly hard.
It still remains to be seen exactly how REITs will fare in the capital markets as a result of the removal of the dividend tax on corporate dividends. The dividend tax excludes from the taxable income of individual investors the dividends they receive each year from corporations, but only to the extent that the company pays taxes on this distributed income. This clearly creates an incentive for corporations to raise dividends, a fact that may make REIT dividends less attractive to some investors. REITs would not receive the same benefit because they already make tax-free distributions, and this could cause a possible loss of REIT share values. In fact, REIT prices already have fallen. The good news? Tax-exempt investors like pension funds, IRAs, and 401K investors could see improved yields from REIT investments.

The Sarbanes-Oxley Act required the SEC to issue rules about the disclosure of pro forma financial information in any report filed with the SEC, or in any public disclosures or releases. Regulation G, as it became known when adopted in January 2003, went beyond the requirements of the Act by restricting the presentation of non-GAAP financial information in SEC filings. Funds From Operations or FFO is considered a non-GAAP financial measure and REITs would have to defend its use as a key measurement of company performance.

Reg G requires that when a company presents non GAAP financial measures, a numerical reconciliation of the non GAAP financial measure must be made to the most directly comparable measurement calculated using GAAP (generally either Earnings per share (EPS) or operating cash flow.) If a REIT elects not to present FFO, it would have to use Earnings Per Share as the measuring tool, in which case depreciation would become a key issue for analysts and investors. For FFO calculations, depreciation is an add-back, so investors paid little attention to the useful life of an asset. By contrast, depreciation expense reduces EPS, and the useful lives of assets would be a key focus of investors if the SEC proposal were adopted.

It has been estimated that the overall impact of Sarbanes Oxley and increased corporate governance requirements on REITs could be anywhere from two to five cents per share on an earnings per share basis. There has been an expectation for some time within the industry that there is another major wave of consolidation coming in the REIT sector. Given the new playing field and it's heightened cost of doing business, this wave of mergers and acquisitions may be even closer at hand and there's also the strong possibility that some REITs will abandon the public arena once and for all and return to private status. Some REITs with weak share prices and portfolios of underperforming assets might improve shareholder returns by merging with larger, stronger REITs by converting to private companies or partnerships, or simply by liquidating assets and passing the proceeds along to investors.

OFF BALANCE SHEET TRANSACTIONS

The Financial Accounting Standards Board in January issued a final rule (Interpretation No. 46, Consolidation of Variable Interest Entities, also known as FIN 46) as to when companies must consolidate variable interest entities, including special purpose entities that have been widely used as off balance sheet financing vehicles. It is estimated that U.S. companies have financed approximately $60 billion of real estate, much in synthetic leases, and another $40 billion of equipment leases through property owning entities that are SPEs. Off balance sheet transactions have also been widely used by homebuilders, REITs, and other real estate companies.

Putting SPEs back on their balance sheets could saddle companies with major debt, raise debt covenant and credit rating issues, and make it more difficult for them to raise capital in the future. As an alternative, companies could dispose of the assets underlying SPEs through sales, sale-leasebacks and other disposition strategies, and a number of companies could follow this route.

One unintended victim of FIN 46 is the residential development sector. Homebuilders typically option land for development several years out and typically this land is held off balance sheet in joint ventures, development partnerships or other such structures until the land is "taken down" for development. Under FIN 46, homebuilders must now determine whether they are required to consolidate these entities - a move that may have significant financial ramifications for many.

FIN 46 came into effect immediately but public companies weren't required to comply with the rule until 10 Qs filed in the third quarter of 2003. For private companies, FIN 46 applies at the end of the first year beginning after June 15, 2003.

OTHER ACCOUNTING RULES

Other new or proposed rules that affect real estate include:

FIN 45 is a new FASB interpretation of a guarantor's accounting and disclosure requirements for guarantees. Because many real estate transactions contain some kind of guarantee, broader disclosure requirements could affect sellers, buyers, lenders, and others who issue guarantees, including the reevaluation of guarantor transactions. This new rule is already having an impact on business strategies in the sector. Look for an even wider impact as companies begin to gauge the impact of this additional disclosure requirement.

Under a clarification of a FASB rule, a portion of the cost of acquiring a property must now be allocated to existing leases, based on whether the lease is valued above, at or below market value. Historically the cost of the acquisition has been allocated between land and building, with the building being depreciated over its remaining useful life and with no value allocated to the in-place leases. This is retroactive to acquisitions since 7/1/01.

These are just the tip of the iceberg. There are many other new guidelines that must be followed by the entire sector or by certain companies operating within the sector - businesses such as opportunity funds, mortgage banks, pension funds and others. For some in the real estate industry, this is a time of tremendous upheaval, of momentous change. The good news is that, for others, this feels like back to the future. Which is to say that, to some degree, we've been here before. There have been times when the industry has had to adjust, reconfigure, regroup. The comforting aspect of all this is, that for as much as the industry has been forced to change or take steps back, it has always, eventually, moved on.

The views expressed by Ms. Reiss in this article do not necessarily reflect the views of Ernst & Young.