Caesars REIT proposal clouded by IRS review

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Caesars Entertainment Operating Co's plan to split off its property holdings into a real estate investment trust was dealt a blow last month when US tax authorities announced a plan for tougher scrutiny of REIT formations, said two sources familiar with the situation. The new IRS guidance injects added complexity and uncertainty into whether a proposed REIT spinoff will be able to achieve tax-free status – potentially putting a dent in recoveries for Caesars debtholders.

Nevertheless, many investors are cautiously optimistic that Caesars will ultimately be able to consummate its plan, albeit with some changes, they said.

At the heart of the matter is the IRS' concern that some spinouts, including REIT transactions, offer companies a way to disguise dividends and other taxable transactions. As such, the IRS plans to stop providing pre-approval for these transactions while it further probes the matter, the agency said in two 14 September announcements.

The review is expected to be completed in 12-24 months, said federal tax attorney Jack Cummings of Alston & Bird.

Meanwhile, CEOC filed an amended restructuring plan last week that indicated broad support from its bank lenders, though it still lacks second lien or unsecured creditor approval, court filings show. The operator stuck to its prior plan to split CEOC into two separate entities – a REIT and an operating company – but it has not yet disclosed the minute details of the proposed real estate company, including which active operating businesses it will house under the propco umbrella, said the sources familiar.

Under current law governing a REIT spinoff, a company must include an active business within the property company. Historically, companies often toss in smaller, inconsequential operations, sources noted.

But last month's IRS guidance put companies on notice that the agency will scrutinize the size of the active businesses that qualify the REIT, as well as other issues related to the largely tax-free REIT spinoff structures.

"There's concern that simply passively leasing casinos back to an operating company doesn't constitute an active business," said Cummings. "That's the primary tax avoidance problem."

In the case of Caesars, investors had largely assumed that the "active business" for the propco would be something small such as a management company or Harrah's Philadelphia, a racino in Chester, Pennsylvania, the sources familiar said. But given the new guidance, Caesars may be forced to evaluate other businesses, they added.

"Everyone expected [the] business development [segment], but that's a few guys looking for deals and most of the value is still from collecting rent which is not active," said a REIT banker.

The IRS also said it would generally stop giving so-called private letter rulings that approve such transactions prior to closing. That means that Caesars will likely have to proceed with its REIT transaction without actually knowing if it will reap the tax benefits that it wants.

Caesars had previously planned to obtain a private letter ruling from the IRS, added the sources. A private letter ruling is typically "thousands of pages long..and people do it to feel extra safe in complex deal," but "you do not need approval from the IRS to do it [a REIT conversion],” the banker said.

“The government thinks it could kill some deals this way because you will have skittish people,” who won’t go through with it without the certainty, he added.

Yahoo, for its part, indicated last month it plans to go forward with its spin-off of Alibaba – which it expects to be tax-free – despite the fact that the IRS rejected its request for a private letter ruling, according to securities filings.

“So long as some lawyer tells you it’s done properly,” it would likely be held up in court, but that is something companies may not want to risk, said the banker.

Fair share

For Caesars, the new IRS guidance “is a big deal because already there are a lot of stakeholders who don’t feel like they’re getting their fair share,” said Alex Bumazhny, an analyst with Fitch Ratings. Without the tax advantages of a REIT spinoff, it could be harder to get junior bondholders’ support for the restructuring, he said.

But even without the tax benefits of a REIT, Caesars’ new propco owners could still get a boost from splitting its operations from its property, said Bumazhny. A typical casino company trades at 7x-9x times EBITDA while a gaming property company could trade at 15x, he said. Case in point, Gaming and Leisure Properties, the REIT formed in 2013 with Penn National Gaming’s real estate, trades at a multiple over 14x, according to Yahoo Finance.

Given today's low interest rates, the market often values properties with a steady income stream at much more attractive levels than operating businesses, according to Reuben Daniels, managing partner at investment bank EA Markets.

"The REIT structure is one component of the value, but the fact is that there's such an immense amount of capital chasing real property and infrastructure assets that just separating the operations is likely to create significant value," Daniels said.

Still, if Caesars opts to proceed with a REIT plan and doesn't get IRS approval, the initial costs are high, according to a tax attorney. "If the spinoff does not qualify as tax-free, then [it will be] taxed on the excess over its basis as if [it was] sold, and that can be a big bill," he said. "On the right set of facts, people will go forward but they will proceed with caution."

UPREIT ahead?

Given the regulatory scrutiny, CEOC may push to change the structure of the plan in a way that would defer rather than eliminate taxes, said the sources. The company already outlined alternative structures in a 24 August SEC filing, including reorganizing into a so-called UPREIT structure.

Typically in the case of an Opco/Propco split, the property company becomes a REIT, which has lower corporate taxes because it is required to distribute much of its profits as dividends to shareholders. Under such scenarios, the property company REIT leases its real estate to the operating business.

In contrast, an UPREIT is essentially an umbrella partnership that can acquire properties on a tax-deferred basis, according to the tax attorney. The UPREIT option may not be subject to the IRS guidance but two attorneys said that route may be less desirable. "I don't know how a company that really wanted to spin off as a subsidiary would proceed with an UPREIT transaction and get to the place it wants to be,” said Cummings.

Caesar’s USD 4.5bn 10% second lien notes due most recently traded on 9 October at 31.25 compared to its trade of 34 prior to the IRS notice, according to MarketAxess.

Meanwhile, the operator’s USD 3bn 9% first lien notes due 2020 traded on 9 October at 80.75 compared to its trade of 84.5 in early September. The issuer’s USD 1.7bn L+ 875bps (1% floor, 99.25 OID) TLB-7 due March 2017 is quoted 89.063/90.875, according to Markit.

Caesars did not return calls.

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by Maura Webber Sadovi and Paunie Samreth