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4 Reasons Macy's, McDonald's Won't Spin Off REITs

By **Andrew McIntyre**

Law360, Minneapolis (November 16, 2015, 3:52 PM ET) -- Macy’s Inc. and McDonald’s Corp. recently announced they are not spinning off certain assets into real estate investment trusts, bucking a trend that companies like Sears Holdings Corp. and Darden Restaurants Inc. have taken advantage of, and lawyers say Macy’s and McDonald’s faced a number of liabilities and uncertainties as they considered the move.

Among the likely issues the two multinational firms faced are uncertainties on tax treatment from the Internal Revenue Service, potential liabilities in having to re-lease their properties and — particularly in the case of Macy’s — a reluctance to give up real estate control amid uncertainty about the future of brick-and-mortar retail.

Here are four issues that lawyers say Macy’s and McDonald’s were up against as they considered a REIT spinoff:

Uncertainty From the IRS

Much of the REIT spinoff activity over the past 18 months has been a result of broadening definitions of real property on the part of the IRS — and of the IRS’ willingness to issue private letter rulings both on whether the “real estate” in question can be spun off and on whether the spinoff can qualify as tax-free.

But amid a wave of recent REIT spinoffs, the IRS announced it would no longer be issuing private letter rulings on the question of whether a spinoff can be tax-free.

And that, lawyers say, could have played a role in the companies' decisions to forgo the spinoff.

“My guess is that McDonald's and Macy’s, without being able to get comfortable ... that a spinoff could be tax-free … they probably concluded that it was too risky,” said Blake Hornick of Seyfarth Shaw LLP.

The IRS couldn’t be reached for comment.

Jim Sluzewski, a spokesman for Macy’s, referred Law360 to the company’s recent third-quarter investor conference call and declined to offer additional comment. A McDonald’s representative could not be reached for comment.

“It is much more difficult to complete a ... spinoff today following recent action by the Treasury … than it was prior to the Treasury's recent action," said Gilbert G. Menna of Goodwin Procter LLP. "We do expect that under the right circumstances, these proposed spinoffs can still occur."

Desire to Control Real Estate

While many companies have eyed REIT spinoff tax benefits — REITs generally don't pay corporate tax — as well as the potential for real property to achieve more value more quickly as a separate unit of the core business, spinning off a REIT does mean a company loses control of the real estate.

And that, lawyers say, may have been a major issue for both companies.

"I would assume it's more nontax considerations," said Laurence E. Crouch of Shearman & Sterling LLP. "Not wanting to lose control of their assets."

Macy's, in particular, faces the complex question of how best to unlock value from its real estate, given the uncertainty of the future of brick-and-mortar retail. The company has partnered with Tishman Speyer Properties LP to explore ways to monetize its real estate.

"It's going to be interesting with Macy's as they're taking a look at this," said Michael L. Hermsen of Mayer Brown LLP. "Do they have too much unutilized or underutilized space? How can they go about dealing with that issue? If they're not using the space, are there ways that they can monetize their real estate?"

Indeed, Macy's in particular may have passed on the spinoff, opting instead to pursue other options on the table for unlocking value. Lawyers, though, say both companies could at a later date revisit the possibility.

"My two cents is that they were worried about the politics of the situation," said George C. Howell III of Hunton & Williams LLP. "I think also they probably as a company decided that their business works better if they control the real estate directly."

Complexity of Spinoffs

While similar companies like Sears and Darden Restaurants have recently done REIT spinoffs, lawyers say such spinoffs must be examined and carefully scrutinized on a company-by-company basis, and certain spinoffs are more complex than others based on myriad factors related to the nature of the real estate assets.

Such deals require a small army of tax, real estate and corporate lawyers to lay out the road map for a spinoff, and the companies may have concluded they didn't see enough potential upside to justify the complexity of the spinoff.

"With the way their real estate was set up, it wasn't as advantageous for them. It would have been a complicated spinoff for them," said Patricia McGowan of Venable LLP, speaking about McDonald's. "I know that other companies are considering them now. It just depends on the type of assets and the current real estate structure, and whether it makes sense."

And Macy's, whose stock is down a whopping 40 percent year-to-date, also faced a complex spinoff, in part because the retailer has various partnerships as it tries to redefine its stores. The company recently partnered with Luxottica Group SpA in a move that will bring hundreds of LensCrafters stores into Macy's.

“I think there will still be some deals done, but deals that are a bit more aggressive and creative that push the envelope probably won’t get done,” Hornick said.

Potential Lease Liabilities

Spinning off assets into a REIT requires a company to lease back those assets from the REIT, and that layer of complexity and uncertainty may have been a major consideration for the companies, lawyers say.

“McDonald's is obviously known for having some pretty prime property spots,” Hermsen said. “If you can spin off your real estate assets, you can monetize them fairly quickly, which can result in a big inflow of cash.

"But you also wind up having to lease all those properties, which can have ongoing liabilities," he added.

Indeed, companies considering a REIT spinoff have to do a careful cost-benefit analysis of receiving proceeds from spinning off real estate assets versus the liability of having to lease those assets back.

And McDonald's and Macy's may have determined that liability didn't justify the potential upsides of a spinoff.

"Your lease costs could go up over time," Hermsen said.

--Editing by Jeremy Barker and Patricia K. Cole.
