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US Real Estate Insights

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Dear Clients and Friends

On behalf of PwC's Real Estate Practice, I am pleased to share with you the latest edition of US Real Estate Insights, which provides perspectives on the latest market and economic trends, regulatory activities and legislative changes affecting the real estate industry as well as informed views of the most current developments in operations, business strategy, taxation, compliance and financing.

This issue includes several articles prepared by members of our Real Estate Practice:

- Susan Smith, the editor of PwC's quarterly Real Estate Investor Survey, highlights which property types and geographic locations hold the most appeal to investors in ***"Encouraging trends revive interest in industrial assets."***
- In ***"Real estate capital market insights,"*** Dennis Trunfino, Lisa Pavelka McAlister and Tim Bodner summarize the encouraging macroeconomic and industry fundamentals pointing to a recovering capital markets environment.
- Kristen Naughton highlights aspects of the JOBS Act that impact real estate companies considering an initial public offering in ***"The JOBS Act of 2012: Jumpstarting the Capital Markets,"*** and discusses the impact of the Act on non-traded REITs.
- In ***"Fate of the joint lease accounting standard,"*** Lou DeFalco summarizes the current status of the long, difficult path towards creating a new lease accounting standard with a particular emphasis on the likely reactions from real estate industry participants.
- ***"Multifamily finance – the role of GSEs and government agencies"*** provides an overview of the impact and role of the GSEs and Government Agencies on the multifamily commercial lending markets. In this article, John Gibson and Amanda Lui explain the implications for GSE housing finance reform.
- In ***"Top 25 lodging markets – Are we there yet?,"*** Abhishek Jain analyzes the recovery paths of the top 25 lodging markets, and delves into possible factors limiting recovery in some markets.
- James Guiry and Adam Feuerstein provide a two-part update on ***"The impact of FATCA withholding on real estate funds, real estate companies and real estate joint ventures."*** Part 1 focuses on US entities and their obligations under this new information reporting and withholding regime. Part 2 focuses on the classification of non-US entities under FATCA and steps that these entities should take to prepare.

We hope you will find US Real Estate Insights to be informative and helpful to you in your business.

As always, we encourage you to share your thoughts, opinions and suggestions. For more information or to be added to our distribution list, please feel free to contact the authors of this edition's articles or your local PwC representative.

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Investors rethink strategies as recovery slows

By Susan Smith

The following is extracted from the Third Quarter 2012 issue of the PwC Real Estate Investor Survey, released on September 17, 2012. The findings and opinions reflect those of the investors surveyed and do not necessarily reflect the views of PwC.

After a strong start to the year accentuated by steady economic growth, vibrant leasing activity, and rising optimism, the long-awaited recovery hit some speed bumps and has noticeably decelerated. "The positive trends that emerged in the first quarter of 2012 have weakened," states a Survey participant. "The momentum I thought we gained heading into the second half of this year has really dwindled," says another. Instead, an air of uncertainty has returned, leaving many investors feeling discouraged and rethinking investment strategies.

While investing in top-performing CBD office metros has been a main priority for various investors, the recent slowdown in net leasing velocity, even in strong markets like San Francisco and Washington, DC, has some investors skittish. "The uncertainty about what will happen with leasing is making us tentative on office deals right now," shares a Survey participant. In addition, rent growth expectations have fallen for many CBD office markets, causing many investors to question the prices being paid for some downtown assets in primary metros.

Overpricing concerns and a search for better risk-adjusted yields are whetting investors' appetite for office assets with quality tenancies in recovering secondary markets, like Denver, Houston, and Phoenix. Instead of looking in the usual 'hot spots,' some are focused on secondary markets with decent fundamentals and decent rent growth potential. Many of the metros targeted in this revived strategy were significantly hurt by the housing crisis, but are now showing positive signs of recovery and stability.

In another strategy shift, a large portion of surveyed investors are looking to increase their exposure to the industrial sector in the months ahead due to the challenges in the office sector. Plus, many investors feel that industrial markets are in a better position to weather a sluggish recovery or "flat" years that could lie ahead.

In the apartment sector, investors are looking to acquire more assets. While high-rise, Class-A assets are still a main focus, certain investors are switching to low-rise, garden-style apartments in infill areas as pricing has increased for Class-A apartment buildings. "We see an opportunity to take on more risk within the US multifamily sector as there is still a preference to rent in this country," remarks a Survey participant.

Overall cap rate trends

In the third quarter of 2012, the average overall capitalization (cap) rate decreased in 23 Survey markets, increased in five of them, and held steady in four. While the number of markets reporting quarterly cap rate declines increased slightly over the past three months, overall cap rate shifts have been quite irregular since the start of the year with movements changing from quarter to quarter in many markets.

One of the largest overall cap rate decreases in the third quarter of 2012 was reported for the national warehouse market, where the average declined 20 basis points. After two quarters of single-digit decreases, this downward shift highlights the industrial sector's recovery and positive outlook among surveyed investors.

While the recovery of the commercial real estate (CRE) industry remains uneven and very location and sector specific, CRE remains a prime target for investment capital as it continues to perform well relative to alternative investment vehicles. Helping to fuel demand for CRE are low interest rates, which surveyed investors feel will not increase anytime soon. As a result, Survey participants expect overall cap rates to hold steady in most Survey markets over the next six months.

Sector overview

Office

Concerns about lackluster US job growth and the resulting slowdown in leasing demand are keeping some investors from placing CBD office building acquisitions high on their priority list. Although the year started off on a positive note with many CBDs reporting vibrant leasing activity, volume fell off during the second quarter and has remained quite stale. In turn, underwriting assumptions used by surveyed investors in the national CBD office market have softened somewhat.

In the national suburban office sector, retaining tenants and raising rental rates have become harder for many property owners over the past three months as the demand for space has waned. As fewer tenants look to expand, even once-dominant suburban office markets, like Northern Virginia and Long Island, are struggling to keep overall vacancy rates from rising.

Even though there are a few "tech" suburban office markets that are outperforming the country as a whole, such as Silicon Valley and parts of San Francisco, property owners in these suburbs also report a slowdown in tenant leasing activity. For now, most tenants looking to lease suburban office space are finding favorable rental rates and are being offered generous concession packages.

Retail

Even though the US regional mall market performed better than the US neighborhood and community center segment in the second quarter of 2012, guarded consumer spending continues to keep the demand for retail space low at many regional malls. In addition, investment sales have followed the same pattern as leasing activity, falling off after a relatively strong start to the year.

For investors looking to acquire regional mall assets, our Survey reveals that prices range from 80.0% to 125.0% of replacement cost and average 97.3%. Additionally, surveyed investors expect regional mall values to decline as much as 20.0% and increase as much as 10.0% over the next 12 months.

In the national power center market, certain investors remain wary of potential acquisitions due mainly to a slowdown in US economic growth. Nevertheless, quality power center assets –- those with dominant big-box merchants, strong locations, and exceptional amenities, can be attractive plays. In fact, investors targeting high-end power center assets are seeing strong competition, leading to lower initial-year returns this quarter.

In the US strip shopping center market, underlying fundamentals are improving in many metros, like Miami, San Diego, and Boston, while other cities, like Tulsa and Birmingham, are seeing supply move ahead of demand. Such leasing challenges make it difficult for many property owners to raise rental rates. In turn, property value appreciation is expected to remain muted for most assets in this property sector over the next 12 months.

Industrial

Optimism prevails among surveyed investors in the US industrial sector despite downbeat news headlines about both international and domestic woes. In fact, many investors note that the recovery underway in the national warehouse market continues to gain momentum due to increased demand and a lack of new supply. Impressive leasing activity has been reported for Los Angeles, Chicago, and various Florida metros.

While demand for warehouse space has mainly been from large corporations – users that lease at least 50,000 square feet at one time, smaller users have become much more active as of late. Increased leasing activity among smaller users suggests that confidence may be growing among businesses with regard to the US economy's future performance.

The outlook for the national flex/R&D market has also improved as both the national warehouse market and national suburban office market show signs of recovery. As flex/R&D market conditions improve, our Survey reveals that buyers have lost some negotiating power in the sales arena. This quarter, 50.0% of Survey participants believe that flex/R&D market conditions favor buyers, down from 66.7% three months ago.

Investors looking for flex/R&D acquisitions are finding some opportunities in West Coast tech markets, like Silicon Valley and San Jose, where rental rates and occupancy levels are higher than many other parts of the country. However, prices there can be relatively high. Other flex/R&D markets targeted by buyers include Boston, Austin, and Seattle, where value appreciation is also being reported.

Apartment

The national apartment market remains firmly planted in the expansion phase of the real estate cycle, characterized by strong demand, solid fundamentals, robust rent growth, and new supply. As a result, many investors are looking to acquire assets in this sector. In the second quarter of 2012, total sales reached $16.2 billion, the highest level since 2007, according to Real Capital Analytics.

Despite steady sales velocity in the Mid-Atlantic, Pacific, and Southeast apartment regions, average overall capitalization rates (OAR) revealed little movement in the third quarter of 2012, paralleling the national apartment market. In our Survey, the Pacific region boasts the lowest average OAR at 5.19% while the averages for the Mid-Atlantic and Southeast regions are slightly higher at 5.67% and 5.74%, respectively.

Within the sales arena, however, surveyed investors' perceptions of current market conditions relative to buyers and sellers vary among the Survey's three apartment regions. In the Mid-Atlantic region, 50.0% of investors believe the market is buyer friendly, while the majority sees conditions favoring sellers in the Pacific region. In the Southeast region, half of Survey participants view conditions as neutral – equally favoring buyers and sellers.

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More information on the PwC Real Estate Investor Survey™ can be found at www.pwc.com/us/realestatesurvey or by calling 1-800-654-3387.

Real estate capital market insights

By Dennis Trunfio, Lisa Pavelka McAlister and Tim Bodner

Economic and capital market conditions have continued to remain challenging and volatile, with present headwinds creating continued uncertainty. Constrained housing activity, fiscal policy uncertainty, credit and financial market stress, and the forthcoming Presidential and congressional elections are among the many contributing factors.

Notwithstanding these conditions, based on activity through August 31, 2012 (the "period"), US REITs have raised $44.0 billion of fresh capital, an increase of $3.0 billion from the comparative prior year period. This trend, as has been the case for a period of time, continues to indicate the relevance of REITs as an asset class in a competitive and challenging market environment – an environment that values and rewards an experienced management team, solid track record, and prudent balance sheet management.

Substantive entity-level merger and acquisition activity has also occurred during the period, with underlying trends and fundamentals providing support for more activity to be seen as industry participants continue to execute upon their strategic priorities.

REIT IPOs

REIT IPOs remained active during the period, although subdued relative to the comparative prior year period and the pipeline of REITs seeking to access the capital markets. There were five REITs that priced during the period, which collectively raised $780.0 million of capital at an average offering size of $156.0 million.[i]

On a sector basis, two of the five REIT IPOs during the period are mortgage REITs and two of the five are retail REITs, one of which historically operated as a non-traded REIT. The remaining REIT IPO is a diversified REIT.

Returns on the first day of trading for the REITs that priced during the period were 7.0%, driven primarily by a 24.6% return from a former non-traded retail REIT.

Relative to the comparative prior year period, only two fewer REITs priced while capital raised declined by $1.2 billion and $94.8.0 million on a per IPO basis.[ii] Sector diversification was also more meaningful during the prior year, with lodging, industrial, and residential being the principal contributors.

After giving effect to current period activity, the pipeline at the end of the period consisted of 17 REITs seeking to raise approximately $5.5 billion of capital. Of the 17, nine have been in the pipeline for at least a year or more and six initially filed a registration statement during the period. Comparatively, registration statement activity in the first eight months of 2012 is down from the prior year period when 16 REITs filed.[ii] Interestingly, shortly after the end of the second quarter of 2012, a registration statement was filed by an east-coast based mortgage REIT thereby becoming the first proposed mortgage REIT to file for a traditional, underwritten IPO in almost a year.

While the verdict the impact the JOBS Act will have on the IPO market still has not been received, it is clear that some companies seeking to access the capital markets are capitalizing on the relief offered. With respect to REITs, five companies in the pipeline have initially filed with the SEC or changed their status to "emerging growth company."[ii] In addition, several trends emerged (or appeared to have emerged) during the period which may provide some indication on the direction of the IPO market as it pertains to REITs.

While these trends allude to positive momentum, investors to date have expressed a preference for existing REITs with an experienced management team and solid track record.

Mortgage REITs

In 2011 and even 2010, REIT IPOs were more diverse on a sector basis as previously alluded to. However, current period trends and pipeline activity suggest that mortgage REITs may be returning to prominence – a trend that was last observed in 2009 when seven mortgage REITs priced.

Many factors may be contributing to this apparent shift, with the two most often observed being attributable to the view that the existing housing finance paradigm must be reformed and perceived opportunities created by the weak macroeconomic climate.

This perceived opportunity, while it may be surprising to some, is based on the premise that lower home prices could keep some borrowers from refinancing their mortgages, despite low interest rates, keeping prepayment rates in check and, in turn, increasing the value a company can produce from leveraged assets.

Time will tell whether we return to 2009 levels; however, it is certainly an opportune time to ponder whether more will be seen particularly with eight potential mortgage REIT candidates in the pipeline and the Federal Reserve recently announcing QE3.

Single family housing

Over the past several years, non-traditional owners of assets viewed as "real estate" have increasingly been drawn to the REIT structure. During the current year, in particular, many non-traditional owners (tower companies, data center operators, and advertising companies) have converted or are contemplating converting from the typical corporate structure to the REIT structure. Potential benefits to converting include the lack of corporate-level taxation and investor interest in yields REITs are generating relative to alternative asset classes. Many, however, may not have thought or considered that single family housing would or could be one of them.

Market activity surrounding single-family housing has, however, been significant, with one possible exit alternative for investors being a public offering as a REIT. Prominent private equity firms and fund sponsors have been associated with this trend and, based on observed activity, are investing significant amounts of capital.

The impetus for this trend may most appropriately be linked to the program announced on August 10, 2011 by the Federal Housing Finance Agency, in consultation with the US Department of the Treasury and the US Department of Housing and Urban Development whereby a Request for Information was issued to solicit ideas for sales, joint ventures, or other strategies to augment and enhance the REO asset disposition programs of the agencies.

While the prominence of those firms that are active and the link to the government may provide some with comfort that this trend is meaningful, many have their doubts given that managing a portfolio of residential properties is inherently different than managing a portfolio of commercial assets – apartments, shopping centers, or office buildings. These differences do not only relate to the economics of ownership, but also the practicality.

Additionally, recently some have expressed concern that price increases driven by demand and constrained supply is resulting or may result in lower economic returns thereby reducing the incentive for investment in certain markets. Whether or not these conditions reverse, particularly on the supply side, is unknown.

As a result, time will only tell. Those firms who are able to optimize the benefits of ownership through achieving economies of scale and resolving practical challenges may represent the next wave of REITs who have forayed into the market, created a new asset class within the REIT sector, and, in part, addressed one of the widely-viewed impediments to stronger economic growth.

Secondary equity offerings

Existing public REITs also continued to raise meaningful amounts of equity capital with $31.7 billion being raised during the current year period relative to $29.9 billion in the prior year.[i]

Significant activity observed is attributable to the behavior exhibited by REITs for a period of time as they continue to exercise prudent balance sheet management to optimize their capital structures and act on accretive acquisition opportunities present in today's market environment when available and consistent with strategic objectives.

Importantly, however, the proportion of preferred stock offered relative to common stock has increased significantly from the comparative prior year period with preferred stock offerings accounting for 25.9% of total secondary offerings compared to 11.3% during the prior year.[ii]

Observed trends in preferred stock offerings demonstrate the value placed on yield by investors despite risks faced by more limited liquidity while issuers are responding to attractively priced capital. With respect to common equity offerings, REITs continue to utilize the flexibility offered by At-the-Market, or ATM, offerings relative to traditional underwritten secondary offerings, a trend that has been observed for some time now.

From a sector perspective, excluding mortgage REITs which accounted for over one-third of total capital raised, retail REITs accessing the capital markets through secondary equity offerings accounted for over a quarter of the remaining capital raised with other sectors accounting for the remainder.

Secondary debt offerings

As an alternative to equity, REITs were also active in the unsecured debt market, with $12.4 billion and $9.5 billion raised during the current and comparative prior year periods, respectively. No secured debt was raised in either period.[i]

From a sector perspective, health care REITs were the most active illustrating a distinction between the trends observed with respect to secondary equity offerings. This distinction may be attributable to a cost of capital advantage that such REITs are able to enjoy, as well as an apparent capital structure bias towards unsecured debt given the nature of leases in place and soundness of associated lessees.

Mergers and acquisitions (M&A)

Historically, real estate M&A activity has generally consisted of individual property or portfolio-level acquisitions with the exception of a prominent Midwest based health care REIT which has been active on the entity-level acquisition front in recent years. This trend has generally remained consistent during the period, although signs have emerged that incremental entity-level M&A activity may occur on a more frequent and substantive basis going forward.

Examples include two substantive acquisition transactions announced by an Ohio-based health care REIT and a California-based owner of single-tenant net lease properties. In addition, M&A activity has been and is expected to continue to be seen outside of the REIT sector, particularly with respect to real estate brokerage firms.[iii]

Consolidation continues to be a major theme with respect to this segment of the industry, as segment market participants continue to experience the effects of the globalization mega trend. This trend, while present for a number of years, has picked up speed as clients of these market participants continue to broaden their geographic reach to capitalize on perceived growth opportunities present around the world rather than traditional markets in which such opportunities are viewed as more limited. This trend presents a favorable opportunity for firms with established and substantive international operations.

As a result, as the trend discussed continues to gain traction, it is widely expected that market participants will be faced with making a strategic decision to either focus on a particular niche or merge with a more established firm which consequently is expected to lead to incremental M&A activity.

Real estate capital markets outlook

Real estate industry capital market activity has been significant, and although there are divergent trends present with respect to the form of capital and the method through which such capital is raised and it is unclear as to the frequency with which entity-level M&A activity will be seen, these trends are expected to continue.

Economic conditions continue to remain challenging and there is significant commercial real estate indebtedness maturing in the near term. While the industry to date has

shown resolve and the capacity to address significant challenges, today's conditions are different and fraught with uncertainty. Individual and portfolio asset sales are expected to continue; however, given the challenges of the financing and refinancing environment, it is likely that industry participants will continue to access the capital markets as well.

For existing public REITs, accessing the capital markets through consummating secondary equity offerings (primarily through ATM programs) is likely to be the method selected.

However, for non-traded REITs, this alternative is not as readily available, if at all.

As a result, it may be seen that certain of these non-traded REITs will seek to affect IPOs although such an alternative may prove to be challenging given the number of REITs in the pipeline and investor preferences expressed to date. Nonetheless, the combined activity of traded REITs, non-traded REITs, non-traditional owners of real estate converting from corporations to REITs, and entity-level M&A will meaningfully contribute to real estate capital market activities.

Further, the recent news surrounding a prominent New York-based private equity firm possibly preparing to monetize its office portfolio may contribute further as potential counterparties seeking to acquire a portion of its portfolio access the capital markets to raise needed capital to effectuate any deal. However, the timing of such a transaction (or transactions) is unknown at this point in time.[iv]

Therefore, although the real estate sector, like any other sector is affected by macroeconomic and other conditions present, the amount of capital raised and apparent trends indicate that the industry activity will continue to be significant throughout the balance of 2012 and the foreseeable future.

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i. National Association of Real Estate Investment Trusts (NAREIT). (2012, August 31).
ii. PwC Analysis (IPO Watch).
iii US Securities & Exchange Commission Form 8-K filings.
iv National Real Estate Investor (2012, July 13).

The JOBS Act of 2012: Jumpstarting the capital markets

By Kristen Naughton

On April 5, 2012, President Obama signed the Jumpstart Our Business Start-ups Act into law. The JOBS Act is intended to spur job creation and economic growth by providing an on-ramp for smaller companies to access the public capital markets. The JOBS Act provides accommodations to a new class of issuer, Emerging Growth Companies or EGCs, and provides a number of accommodations to these companies.

What is an emerging growth company?

An EGC is an issuer that had less than $1 billion in total annual gross revenues during its most recently completed fiscal year.

An EGC as of the first day of its fiscal year will continue to be an EGC until the earliest of:

i. The last day of the fiscal year during which it had total annual gross revenues of $1 billion or more;

ii. The last day of the fiscal year following the fifth anniversary of the first sale of the issuer's common equity securities in an offering registered under the Securities Act (equity IPO);

iii. The date on which the issuer has issued more than $1 billion in non-convertible debt securities during the previous three-year period; or

iv. The date on which the issuer becomes a large accelerated filer (generally, a company with a public float of at least $700 million).

Companies that did not complete an initial public offering of equity pursuant to an effective registration statement prior to December 8, 2011 can qualify for EGC classification.

New REITs likely to reap the benefits of EGC qualification

We expect that many newly formed and roll-up REITs will initially be EGCs. REIT growth is typically dependent upon access to new capital as the dividend requirements restrict growth through reinvestment, as such many new REITs will have less than $1 billion in revenues. Companies that have been active in securitization transactions should be cognizant of the rolling three year debt issuance test. The issuance of the debt securities associated with the securitization are included in the $1 billion debt issuance test; however, bank debt is generally excluded from the debt calculation if it is not

considered a security. Many exchange traded REITs are not likely to remain EGCs for the full five years after the initial equity offering. In fact, over a third of the REIT IPOs that have closed in the past five years that would have qualified as EGCs have since become large accelerated filers because their public float exceeded $700 million.

Testing the waters with potential investors

The JOBS Act amended the Securities Act of 1933, to allow broker-dealers to distribute research reports about EGCs to potential investors in connection with a proposed public offering of equity. The JOBS Act also allows an EGC or its agent may communicate with potential investors, who are qualified institutional buyers or accredited investors in order to "test-the-waters" and determine the level of investor interest as well as an indication of pricing. The JOBS Act provides that these interactions do not constitute offers to sell or buy securities. Because the REIT capital market shifts quickly, the ability to test the waters is viewed by some REITs considering an IPO to be the JOBS Act accommodation from which they will obtain the most benefit. ECGs should work closely with their securities counsel to ensure compliance with these rules.

"Confidential" review of offering documents

The ability to confidentially submit draft registration statements for SEC review has been well received by potential EGCs. The confidential submission review process is similar to the process followed by the SEC with public filings. Companies are expected to submit a substantially complete registration statement for review. When discussing the differences between preparing a confidential submission versus a public filing, one REIT CFO told us, "We didn't see too much of a change [to our process]." The SEC Staff has indicated that a substantially complete submission includes exhibits and all financial statements that would be required if the document were being filed, including the financial statements of acquired businesses and real estate operations or significant equity method investees. At the June 27, 2012 Center for Audit Quality SEC Regulations Committee, the SEC staff indicated that they had received some confidential submissions that were not substantially complete and had deferred review of these documents until a substantially complete document was submitted. Companies should be aware that no less than 21 days prior to beginning a road show, the EGC is required to publicly file a registration statement with the SEC and attach all previous submissions as exhibits to that registration statement. As such the confidentially submitted drafts related to offerings that progress to a road show will be published prior to the road show. Furthermore comment letter correspondence, even those related to the confidential submissions, will be made public by the SEC no earlier than 20 business days following the effective date of the registration statement.

Scaled disclosure requirements

A perceived barrier to IPO for smaller companies was the requirement to provide three years of audited financial statements. Congress provided an accommodation for EGCs whereby they would only be required to file two years of audited financial statements in an initial registration statement, and selected financial data as of the earliest year that audited financial statements are provided. We understand that some EGCs have not taken advantage of this accommodation in their initial filings and have included three years of audited financial statements and selected financial data for the corresponding periods in the

registration statement if audited financial statements are available for these periods. In many REIT roll-up transactions the REIT sponsor may contribute properties that it controlled to a new entity and the new entity may separately acquire additional properties in the years leading up to an IPO. Depending upon the structure, the financial statements of the new entity and the financial statements of the predecessor (for accounting purposes) may not be comparable. It remains to be seen whether EGCs and their underwriters will prefer the two year presentation over having to explain the accounting conclusion regarding the predecessor financial statements to potential investors where the property portfolios changed significantly in the third year prior.

Choice of timeline for adoption of new or revised accounting standards

The JOBS Act allows EGCs to elect to adopt new or revised accounting standards issued after April 5, 2012 using the same timeframe as private companies (if the standard applies to private companies). Once the election to take advantage of the private company accounting transition is made, EGCs must apply the election (as applicable) to all new or revised accounting standards. An EGC may "opt out" of the election while it continues to be an EGC but once it begins following the public company adoption timeframe it may not re-elect the private company adoption timeframe. One REIT CFO said of making the decision whether to elect the private company adoption timeframe, "My initial reaction was to just follow the public company adoption timeframes, but upon additional consideration we decided, why not give ourselves the flexibility?" New REITs could benefit from this accommodation because if a complex new standard is issued, which allows private companies to adopt the accounting standard under longer transition provisions, then EGCs that have made this election would have additional time to work through it. The SEC has indicated that this election to adopt private company accounting transition will be made and disclosed in an EGC's initial submission. If an EGC makes this election, the SEC Staff has indicated that they will expect disclosure of a risk factor explaining the election and the indication that the EGCs financial statements may not be comparable to the financial statements of companies who adopt new or revised standards following the public company effective dates. A similar discussion should be provided in the EGC's critical accounting policies disclosures.

Public disclosure of executive compensation

Non-public companies are not accustomed to publicly disclosing compensation of their executives in the level of detail required of public companies. The JOBS Act provides for scaled disclosures regarding executive compensation for EGCs. EGCs are required to provide the summary compensation table and related narrative, which includes disclosure of the material terms of executives' compensation agreements. One notable difference is that EGCs are not required to include a compensation discussion and analysis in the registration statement, which would include robust discussion of the various compensation plans and the compensation committee's analysis of what each of the named executive officers had been paid. This accommodation has a much larger impact on internally managed REITs than externally managed REITs, which have no direct employees. In addition, EGCs will be temporarily exempt from certain existing and future compensation disclosures such as "say on pay," and "CEO pay ratio." The SEC Staff has indicated that EGCs should include a risk factor that describes exemption from the disclosures as well as the exemption from shareholder "say on pay" and related requirements. Some EGCs may elect to disclose all of the compensation disclosures required for public companies due to the intense scrutiny over executive compensation in recent years.

Temporary exemption from audit of internal controls over financial reporting

Twice in recent years, Congress has chipped away at the Sarbanes-Oxley Act's requirement for companies to obtain an audit of their internal controls over financial reporting. First, with the Dodd-Frank Act, which permanently removed the Sarbanes-Oxley Act Section 404(b) internal control over financial reporting audit requirement for non-accelerated filers (registrants with less than $75 million in public float); and second, with the passage of the JOBS Act, which provides EGCs with a temporary exemption from the internal control audit requirement. However, EGCs are required to complete and file management's assessment of the effectiveness on the internal controls over financial reporting beginning with their second annual report. As noted above, many REITs that initially qualify as EGCs may become large accelerated filers prior to the fifth anniversary of the initial equity offering; therefore the benefit of the temporary exemption from the audit of internal controls over financial reporting requirement may be minor.

Impact of JOBS Act on non-traded REITs

Prior to the JOBS Act, REITs with greater than 500 shareholders of a single class of shares were subject to SEC reporting requirements even though their shares were not listed on a national exchange, these REITs are commonly called non-traded REITs. The JOBS Act changed the shareholder threshold from 500 holders of record to either 2,000 persons or 500 persons who are non accredited investors. The JOBS Act also clarified that employees who were granted shares of their employer's stock pursuant to certain employee compensation plans are not included in the definition of holders of record. However, Congress did not amend the threshold governing the deregistration of companies other than bank holding companies that were required to register as a result of having greater than 500 shareholders; therefore those non-traded REITs that have previously registered their equity, are required to continue reporting until they meet the previously existing rules for deregistration. An existing non-traded REIT may benefit from the JOBS Act because if it has not had a public equity offering, it may qualify as an EGC. Similarly, REITs that do not have public equity but have outstanding public debt securities could also qualify as EGCs. If these types of REITs continue to meet the revenue and debt issuance criteria it appears that they could remain EGCs indefinitely because the five year clock would not start and they do not have public float without a public equity offering. It remains to be seen whether the SEC will adopt additional rules that would result in an exit trigger for these types of REITs.

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Fate of the joint lease accounting standard

By Lou DeFalco

The FASB and IASB (the “boards”) have travelled a long, hard road in moving their joint leasing project forward over the past two years. That road has included many bumps, twists and turns and reversals of tentative decisions along the way, causing some fatigue among those who follow this project. However, as 2012 draws to a close, re-exposure of the proposed standard is imminent. The board is expected to issue a revised exposure draft during the first quarter of 2013.

While there are still several fundamental changes introduced by the proposed standard, which will have far reaching implications across many businesses, the impacts to the real estate industry might not be as dramatic. The proposed standard may produce results which are not too dissimilar from the results under the current models that exist today. This is likely to be viewed favorably by most real estate industry participants. In this article, we will explore how the model evolved and will also raise some of the questions which remain to be answered, as well as, some challenges that may exist.

How did we get here?

Before discussing how the real estate industry may benefit from the decisions on the dual model approach for both lessees and lessors, it is worth providing a little background and context. Leasing arrangements satisfy a wide variety of business needs, from short-term asset rentals to long-term asset financing. Leases allow lessees to use a wide range of assets, including office and retail space, equipment, trucks/cars, and aircraft, without having to make large initial cash outlays. Sometimes, leasing is the only option to obtain the use of a physical asset when it is not available for purchase (for example, it is generally not possible to buy one floor of an office building).

Many observers have long believed that the current lease accounting model is not consistent with the FASB and IASB’s conceptual frameworks, which provide the underpinnings for their accounting standards. They argue that the model allows lessees to structure lease transactions to result in operating lease classification and therefore receive off-balance sheet treatment. Critics also point out that the current standards permit something as seemingly illogical as a commercial airline not reporting any airplanes on its balance sheet.

As part of their global convergence process, the boards added a joint project on leases to their agendas in 2007 and have been working since to create a single, comparable, worldwide leasing standard. The initial exposure draft published by the boards in August 2010 was a follow up to a discussion paper published in March, 2009.

When published in August 2010, the exposure draft introduced many fundamental changes to the leasing models which exit today. The boards' primary objective with the initial exposure draft was to get all leases onto the balance sheet of lessees. However, the accounting proposed would significantly impact the income statement, and the changes to expense recognition and income statement presentation quickly became a significant area of focus.

Over 800 comment letters were received in response to the initial exposure draft. A majority of the letters were supportive of the need for the project in general, especially with respect to the balance sheet issue for lessees. However, most respondents had significant concerns about many aspects of the proposals and strongly encouraged the boards to take the time necessary to produce a standard that is both high quality and operational. Common concerns centered on:

- Financial statement impact (especially the income/expense recognition patterns)
- Complexity/operability
- Highly subjective estimates and judgments
- Time to implement
- Cost vs. benefit

In early 2011, the boards began redeliberations to address these concerns and other issues. In discussions over the past 18 months, the boards identified alternative approaches to reduce complexity and address certain application issues. They also conducted extensive outreach with users and preparers to understand the operability and usefulness of their alternative approaches.

Where are we now?

At their July 17, 2012 joint meeting, the boards substantially completed their redeliberations and instructed their staffs to begin drafting a revised exposure draft. The boards expect to issue the revised exposure draft during the first quarter of 2013 with a 120-day comment period. The most significant changes to the initial exposure draft will include: a dual model for lessees and lessors; a higher threshold for including extension options when measuring lease assets and liabilities; simplified treatment of many types of variable lease payments; and new guidance on applying the concept of "specified asset" and "control" when determining whether a contract contains a lease.

A deeper dive into the dual model for lessees and lessors

By far, the most significant change from the initial exposure draft relates to the migration from a single model for all lessees to the dual model tentatively decided in June 2012. There were also some significant changes to the two potential lessor models which were introduced in the original exposure draft.

The dual lessee model

The original exposure draft implicitly treats all leases as financing transactions with the combination of amortization of the right-of-use asset, typically on a straight-line basis, and interest expense, calculated using the effective interest rate method, creating an accelerated expense recognition pattern. Both preparers and users of financial statements across a wide range of industries had significant concerns about this front-loaded expense recognition pattern and the effect on key ratios of separately presenting amortization expense and interest expense, rather than presenting a combined rent expense within operating expenses.

After much debate the boards tentatively decided there should be a distinction in the expense recognition pattern, with a straight-line pattern (the "single lease expense approach" or "SLE") for some leases, and the initial exposure draft's front-loaded pattern

(the "interest and amortization approach" or "I&A") for others. The determination of which approach to apply is based on a "principle" of consumption with a practical expedient based on the nature (property or non-property) of the underlying asset.

Although the lease expense recognition patterns would be different, both approaches would require the right-of-use asset and lease liability to be recorded on the balance sheet, except for leases meeting the definition of "short-term" (defined as a maximum possible term of less than 12 months). The liability would be initially measured at the present value of the lease payments and subsequently measured at amortized cost using the effective interest method. The right-of-use asset would initially be measured at an amount equal to the lease liability plus initial direct costs.

However, the I&A approach requires interest expense (relating to the lease liability) and amortization expense (relating to the right-of-use asset) to be reported separately in the income statement, consistent with the initial exposure draft. In contrast, the SLE approach requires the lessee to allocate total lease payments, including initial direct costs, evenly over the lease term, irrespective of the timing of lease payments, to calculate the periodic straight-line expense. Interest expense relating to the lease liability would be recognized in the same way as under the I&A approach. However, the right-of-use asset amortization expense would be a balancing figure, calculated as the difference between the periodic straight-line expense and the interest cost on the lease liability. Amortization of the right of use asset and interest relating to the lease liability would be reported in a single item in the income statement — "lease expense."

It is presumed that leases of property — defined as land and/or a building or part of a building — should be accounted for using a straight-line expense recognition pattern. This presumption is overcome if:

- The lease term is for the major part of the underlying asset's economic life; or
- The present value of the fixed lease payments accounts for substantially all of the fair value of the underlying asset.

For leases of assets other than property — such as equipment – it is presumed that lessees should apply the approach proposed in the initial exposure draft, unless:

- The lease term is an insignificant portion of the underlying asset's economic life; or
- The present value of the fixed lease payments is insignificant relative to the fair value of the underlying asset.

The dual lessor model

Similar to lessee accounting, the boards are proposing two types of approaches for lessors in accounting for their lease arrangements. The decision is between (1) an approach that is similar to the straight-line operating lease accounting of today, with no derecognition of the underlying asset or gain/loss on lease commencement, and (2) the "receivable and residual approach." After considerable debate, the boards concluded that the dividing line between the two approaches should be the same as for lessees (i.e., it would be based on an underlying consumption concept with the same practical expedients as described above).

When the lessee does not have a right to acquire or consume more than an insignificant portion of the underlying asset (typically presumed for leases of property), the lessor will apply an approach similar to existing operating lease accounting. Under this approach:

- The underlying leased asset remains on the balance sheet of the lessor.
- No lease receivable or gain/loss is recorded at lease commencement.
- Rental revenue is recognized on a straight-line basis over the terms of the respective leases.
- Unbilled rents receivable represent the cumulative amount by which straight-line rental revenue exceeds rents currently billed in accordance with the lease agreements.

When a lease gives a lessee the right to acquire or consume more than an insignificant portion of the underlying asset (typically presumed when the underlying asset is not property), the lessor will apply the receivable and residual approach. Under this approach, a lessor at lease commencement will:

- Derecognize the entire carrying amount of the leased asset.
- Recognize a receivable measured at the present value of the remaining lease payments, discounted at the rate the lessor charges the lessee.
- Recognize a residual asset, measured as an allocation of the carrying amount of the underlying asset. This residual comprises a gross residual asset and a deferred profit element discussed below.

Under the receivable and residual approach, day one profit is recognized on the portion of the underlying asset conveyed to the lessee via a right-of-use. This profit would be measured as the difference between the present value of the lease receivable and the cost basis of the underlying asset allocated to the lease receivable. Any profit on the portion of the underlying asset retained by the lessor (related to the lessor's residual interest in the leased asset) would be deferred and only recognized when the residual asset is sold or re-leased. If the underlying asset is re-leased, a new lease calculation for profit to be recognized over the new lease term is performed, with a portion of the remaining profit deferred. If the underlying asset is sold at the end of the lease term, the remaining profit would generally be recognized.

Where do we go from here?

Reactions from real estate industry participants

As mentioned above, most real estate industry participants will not be dissatisfied with the direction the boards have taken the project. This is largely because, as lessors, owners and operators of real estate property will typically have similar results to today's accounting (with the real estate assets on their books and rental revenue recognized on a straight line basis over the lease term.) But it is also because the decisions made regarding the dual profit and loss recognition model for lessees will also be viewed favorably by those lessees of real estate. Accordingly, owners and operators of real estate may not have as many concerns around potential business implications which may have been driven by changes to their lessees' businesses as a result of the original proposed standard. Since most lessees of real estate will also qualify for the SLE profit and loss recognition model which was described above, there is not likely to be a large catalyst for change in overall corporate real estate strategy used by lessees. However, because all leases will be recorded on balance sheet for all lessees, the new standard may lead to some changes for real estate lessees despite the similar profit and loss recognition model.

Some questions and challenges remain

Reactions from other industry participants (particularly those involved in significant equipment leasing) might not be as positive. Having two models and applying the practical expedient to different fact patterns is expected to add fuel to the debate, particularly for those participants that do not fit neatly into the practical expedients provided. For example, equipment lessees or lessors who are used to structuring their leases as operating leases today will have some significantly different accounting results under the proposed standard as there is such a high hurdle to argue out of the I&A profit and loss recognition pattern for lessees (or the receivable and residual approach for lessors) for assets other than property. Some of the questions this could generate include:

- What is meant by "substantially all"? What is meant by "insignificant"? Are they purely quantitative thresholds (e.g., 90%, 10%)? Does this fundamentally create new bright lines?
- Should one interpret "property" to mean land or a building, or part of a building ("international view") or to include a broader "real estate" definition ("U.S view") that includes "integral equipment," such as cell towers?
- Will "fragmentation" between property and non-property items included in the same arrangement be

required? For example, if there is a single contract with more than one lease element (e.g., land, building, and equipment) is there a requirement to break out each respective component and evaluate it separately, potentially with a different expense recognition pattern for each? In applying the practical expedient to long-term land leases (e.g., those greater than 25 years), the economic result would likely indicate the lessee is obtaining "substantially all" (if that concept is, say, greater than 90%) of the fair value of the underlying asset and would imply that the I&A model is appropriate. However, wouldn't this be inconsistent with the underlying concept of consumption?

- How would the practical expedient apply in re-lease situations? For example, how would one account for a 5-year lease granted in year 45 of an asset's 50-year life?

Many respondents to the revised exposure draft are likely to challenge the boards' decision to apply a lessor model that is symmetrical with lessee accounting. For example, they may question whether:

- Consistency with the revenue recognition proposals (e.g., when license revenue is recognized) would be preferable.
- A property/non-property distinction is appropriate (e.g., for multi-tenant equipment leases, such as satellites and telecommunication antennas, which have many characteristic in common with property).
- It is intuitive that the leased asset (or at least a portion of it) appears on both the lessee and lessor's balance sheets, when the lessor applies the operating lease accounting approach.
- A dividing line based on the lessor's business model would better reflect the economics.

Similar questions to those facing lessees also exist in applying the practical expedient to long-term land leases (e.g., those greater than 25 years for lessors). The economic result would likely indicate the present value of the lease payments made by the lessee would account for substantially all of the fair value of land and would imply that the "receivable and residual approach" is appropriate and the lessor would recognize day one profit. However, this result appears on its face to be inconsistent with the underlying concept of consumption for land leases.

The path forward

The boards are expected to issue the revised exposure draft during the first quarter of 2013. Based on this timeframe, issuance of a final standard, may well slip into 2014. Although the effective date has not yet been discussed, it will likely not be before 2016. Preparers will need to apply the guidance to all leases existing as of the beginning of the earliest comparative period presented.

The journey towards attempting to solve the accounting and reporting issues for leasing transactions has proved to be an eventful and difficult endeavour. Although much progress has been made, it is probably safe to assume there will be a few more bumps in the road, or twists and turns before crossing the finish line.

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Multifamily finance – The role of GSEs and government agencies

By John Gibson and Amanda Liu

On February 21, 2012, the Federal Housing Finance Agency (FHFA) released a strategic plan for the reform of Government Sponsored Enterprises ("GSE") that included the goal of decreasing the level of GSE participation in the residential mortgage markets. The FHFA's strategic plan recognizes that separate solutions are required for multifamily and single-family programs. The plan states:

"Unlike the single-family credit guarantee business, each Enterprise's multifamily business has weathered the housing crisis and generated positive cash flow."[1]

In light of this statement, both the National Multi Housing Council (NMHC) and the National Apartment Association (NAA) issued a statement commending the FHFA for advocating a separate multifamily solution. While the government's involvement in the complex and recently volatile single family business has been in the spotlight, it seems the time has come to review and recognize the role that the government has played in multifamily financing as well.

Overview

The federal government participates in the multifamily housing finance market through various agencies, each performing different roles toward ensuring liquidity and stability in the multifamily capital markets. The GSEs do not directly originate multifamily loans; rather, they primarily purchase qualifying multifamily loans to hold in their own portfolios, or to repackage them for sale to investors as guaranteed mortgage-backed securities.

Although the GSEs were originally chartered as privately-owned corporations, they recently were placed in the conservatorship of the Federal Housing Finance Agency and receive capital support from the US Treasury. While their original charter did not provide an explicit government guarantee, this guarantee has traditionally been considered an "implicit" government guarantee. However, after they were placed in conservatorship, the guarantee provided by the GSEs, and their credit rating, has been linked to the federal government.

1 FHFA: A Strategic Plan for Enterprise Conservatorships, February 21, 2012

The Federal Housing Administration ("FHA") is a government agency that provides direct mortgage insurance that guarantees multifamily loans originated by approved lenders (i.e. acquisition, construction). In return, the FHA receives a fee in the form of a mortgage insurance premium paid by the borrower. The FHA does not originate loans, nor do they purchase loans or originate mortgage-backed securities.

Ginnie Mae is a wholly-owned government corporation that issues mortgage-backed securities comprised of federally insured or guaranteed loans, including FHA loans. Ginnie Mae securities are the only mortgage-backed securities to carry the full faith and credit guaranty of the United States government.

Fannie Mae, Freddie Mac and Ginnie Mae are commonly referred to as "Agencies", as their implicit and explicit federal guarantees help remove the credit risk involved in the loans. Together with the FHA, they are the primary government vehicles for ensuring the ongoing liquidity of the market of multifamily financing.

Agency multifamily mortgage-backed securities ("MBS") products

Agencies participate and provide liquidity in the multifamily market through the issuance of various MBS products. Some of the Agency multifamily products are traded as single-pool MBS, including project loan certificates (Ginnie Mae II MBS), DUS MBS, DUS Mega, and others. The single-pool MBS is also referred to as "Pass-through" certificates, as the investors are entitled to all the principal and interest payments passed through from the underlying loans.

As a result of this structure and reduced credit risk, these MBS pools are more liquid than the underlying loans and can be traded in the secondary market directly or pooled into a Real Estate Mortgage Investment Conduits ("REMIC") or other structured finance issuances.

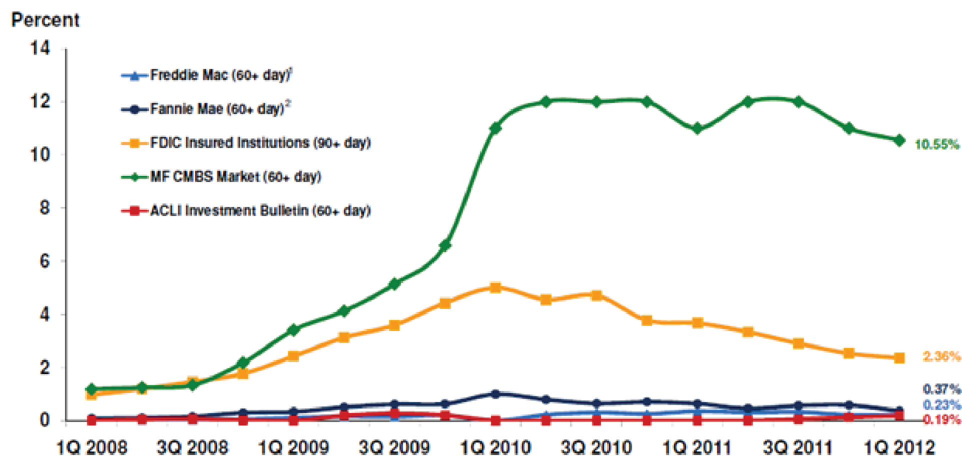
Other products, such as REMIC issuances, are structured to provide investors with the benefit of diversification of the underlying collateral pool by being collateralized by MBS pools, as well as the improved liquidity of a larger issue size. Unlike traditional pass-throughs, the payments in REMICs can be divided into different streams to create classes with different maturities, interest rates and seniority/subordination levels. REMIC and other structured transaction issuance can be tailored to meet these investors risk/return profiles and the specific expected investment horizon, as needed. The existence of strong call protection provisions from the underlying collateral can help minimize voluntary prepayments and negative convexity in a low interest rate environment for certain periods and other features can be structured to meet specific needs for an investor.

Agency multifamily MBS performance

Generally speaking, the Agencies' underwriting standards in the multifamily market are more consistent and stringent than non-Agency standards. This is evidenced by the low delinquency rates experienced on Agency issuance.

As displayed in data from Freddie Mac below, Agency multifamily pools have performed significantly better than non-Agency multifamily loans in terms of delinquencies (60+ day); as of March 2012, Agency delinquency rates were less than 1 percent, while Non-Agency CMBS multifamily loans had a delinquency rate of 10.55%[2] (see chart).

Multifamily market and Freddie Mac serious delinquency rates



Source: Freddie Mac, Fannie Mae, FDIC Quarterly Banking Profile, TREPP, American Council of Life Insurers (ACLI). Data as of March 31, 2012

In addition, Agency financing costs have been lower because of the higher quality performance of the underlying loans, better liquidity in the secondary market and the implicit or explicit federal guarantees. As the result of the guarantee, credit spreads for Agency multifamily securities are tighter and less volatile than those for non-agency AAA CMBS securities. For example, as of June 2012, the credit spread for 10 year Fannie Mae DUS MBS pool was 87bps above Treasuries, while for non-agency AAA CMBS securities, the spread was 224bps.[3]

Overall agency market share

Due to the characteristics described above, over the past few years, Agency multifamily issuance has gained impressive market share and an increasingly important role in contributing funding and stability to the multifamily sector.

The recent growth in overall market share was illustrated in the Mortgage Banker Association (MBA) Quarterly Analysis of Commercial and Multifamily Mortgage Debt Outstanding Q2 2012 report. Agencies owned or guaranteed $198bn, or 30%, of all outstanding multifamily loans in 2008. By Q2 2012, the Agencies' involvement reached $360bn, or 44%, of all outstanding multifamily loans.

With regards to Agency mortgage-backed securities issuance, during the first half of 2012, Agency multifamily REMIC issuance had exceeded $24bn, which represents a 72% increase from the same period last year. The largest increase comes from Fannie Mae. Its issuance volume in the first half of 2012 has exceeded the total issuance in CY 2011. Freddie Mac's issuance volume doubled from the same period last year. Ginnie Mae also has seen an increase of 22% from the same period in 2011 (see table).

	H1 2011*	CY 2011	H1 2012*
Ginnie Mae REMIC	7,727,760,980	15,133,594,120	9,392,729,966
Fannie Mae REMICs	1,557,737,070	4,822,887,744	4,870,991,938
Freddie Mac K Deal	4,814,898,837	13,658,171,149	10,001,754,884
Total	**14,100,396,887**	**33,614,653,013**	**24,265,476,788**

Based on information published by Ginnie Mae, Fannie Mae and Freddie Mac.
* As of June 30

2 Freddie Mac Update – July 2012
3 Credit Suisse, "CMBS Market Watch Weekly," June 28, 2012

In addition, during the first half of 2012, Fannie Mae issued $13.8bn of single pool multifamily MBS product, a 34% rise from the same period in 2011. During the same time period Freddie Mac issued $11.3bn of single pool multifamily MBS product, which is expected to exceed 2011 sales by 40%.[4] As of May 2012, Ginnie Mae had issued $7.2bn of single pool multifamily MBS product, which is an increase of 4% from the same period last year.[5]

Regulatory considerations

There are currently two significant financial market reforms that are still in the proposal stage; the Dodd-Frank Act's risk retention rule for asset backed securities and the Basel III framework. In their current forms, both contain beneficial aspects related to Agency multifamily issuance.

The Dodd-Frank Act's risk retention proposals require banks that securitize loans to retain 5% of the credit risk on their balance sheet. While the proposal is set to align the interests between sponsors and investors, some have raised the concern that the risk retention rules may raise borrowing costs and limit the availability of credit and liquidity. Based on the proposed regulation however, GSEs would be exempt from the risk retention requirements while they are still under conservatorship.

In addition, the proposed Basel III framework establishes higher risk-weighting for bank assets; however preferential risk weighting is given to both GSE and other federally guaranteed CMBS, as compared to non-Agency CMBS.

The results of both of these reforms as currently proposed could make Agency multifamily financing even more favorable, and may lead to increased issuance and demand for Agency multifamily securities.

Conclusion

The Agencies involvement in the multifamily financing market has contributed to lower financing costs, better liquidity, and stability within this sector. While much of the perceived benefits and increased market share of Agency multifamily financing may be due to implicit and explicit federal guarantees and consistency in underwriting of loans, the issuance of federally backed securities and mortgages will likely continue to be debated politically, and addressed through evolving regulatory reform proposals.

In addition, as both the Dodd Frank risk retention rules and Basel III framework in their current forms would help continue certain competitive advantages for Agency multifamily securities, it will be interesting to see how these proposals will evolve with respect to their treatment of Agency securities. However, one thing is clear; the role of the Agencies in the multifamily financing market is significant and impactful, and both the benefits and costs of this role should be carefully assessed and understood with regards to enacting reforms and legislation.

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4 Wsj.com July 13, 2012
5 Ginnie Mae "Issuance Summary Report" as of May 2012. http://www.ginniemae.gov/media/reports2012.asp?Section=Media

Top 25 lodging markets – Are we there yet?

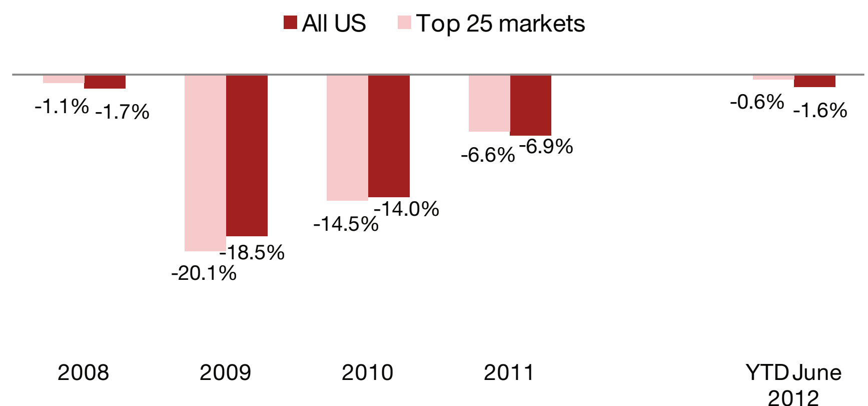
By Abhishek Jain

Hotels are recognized as a commercial asset class that experiences short-term shifts in performance and which is management intensive, requiring frequent monitoring of operating performance to enhance real estate value. Recent trends in the lodging sector underline such perceptions. Not only have national results swung quickly from recession to recovery, but market-specific results have diverged, resulting in differing results even among the top 25 metro areas, measured by the number of hotel rooms ("Top 25 markets"), that are the primary focus of institutional investors.

How are the operating performance recovery rates different across the Top 25 markets? What are some of the contributing factors for the differences in recovery patterns? To address these questions, PwC conducted a market-by-market analysis of revenue per available room ("RevPAR") recovery in these top markets.

Setting the national context, hotels ended 2011 on a positive note, with US RevPAR up 8.2% from 2010. This strong growth was driven largely by solid occupancy increases, which contributed to over 50% of RevPAR growth, combined with the beginning of a pricing recovery. As a result, while RevPAR had fallen to a level in 2009 that was 18.5% below its 2007 peak, by 2011 that gap was narrowed to only 6.9% below. More recently, US hotels have continued to show the strength of the recovery, with RevPAR during the first half of 2012 increasing 8.0%, compared to the same period last year, reaching a level that is now only 1.6% below the RevPAR peak experienced in the first half of 2007 (see Chart 1). This recent performance has been driven more by average daily rate ("ADR"), providing signs of a transition to a price-based recovery.

Chart 1– US and Top 25 Markets RevPAR, Percentage difference relative to 2007



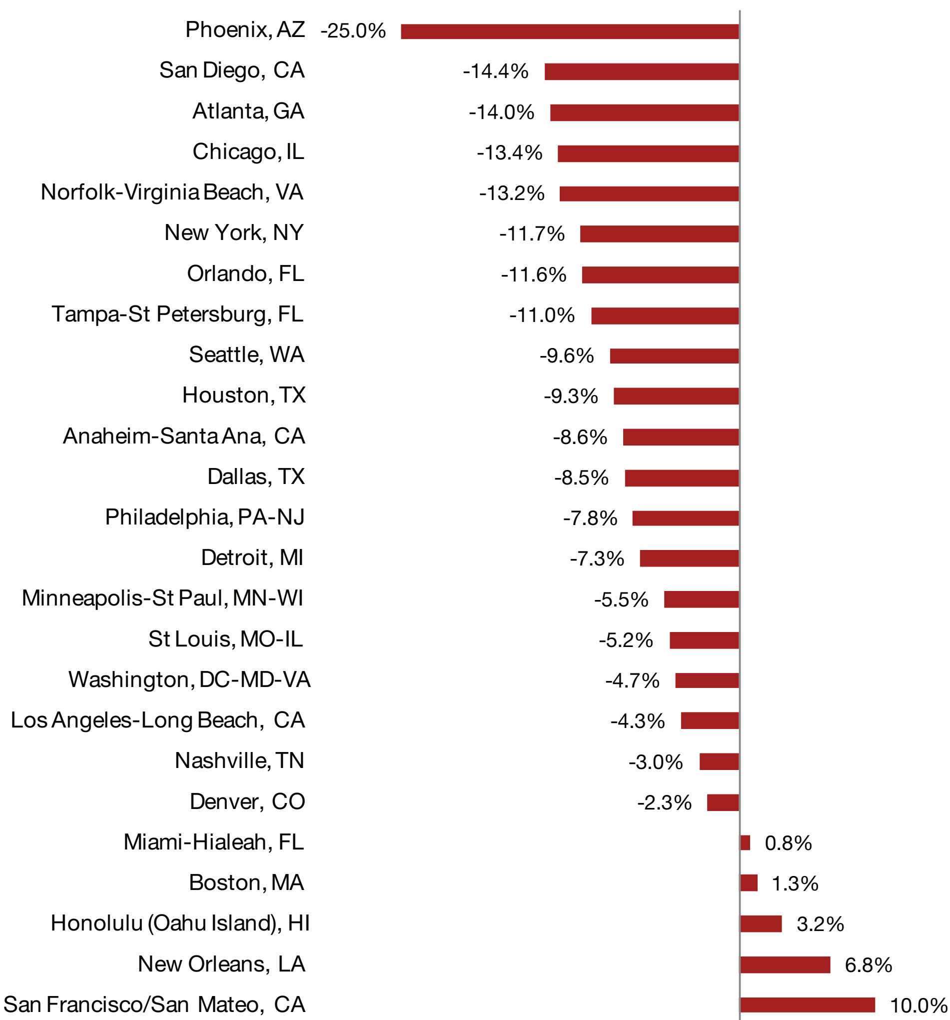
Source: PwC, based on Smith Travel Research

Similar to the national trend, aggregate performance in the Top 25 markets has shown signs of recovery, but there are clear differences across markets. Indeed, at the lower end, Phoenix RevPAR in 2011 was 25.0% below its 2007 level, while at the upper end, San Francisco/San Mateo RevPAR was 10.0% ahead of its 2007 level (see Chart 2). What are some of the common themes driving these differences? Analysis of RevPAR recovery trends in the Top 25 markets reveals that those that continue to be substantially below the 2007 peak RevPAR level have at least one of the following two factors that are limiting their recovery.

1. *Greater reliance on, and limited recovery in, group travel, which continues to lag the recovery in transient travel*. Group travel in the Top 25 markets fell more steeply than transient travel during the recession, with the contribution of group occupancy at the Top 25 markets reaching a 2009 level that was 21.7% below the 2007 peak. Though group activity in the Top 25 markets improved in 2011, and continued to improve during the first half of 2012, group occupancy is still approximately 10.0% below 2007 peak levels, while transient occupancy has exceeded 2007 peak levels (see Chart 3).

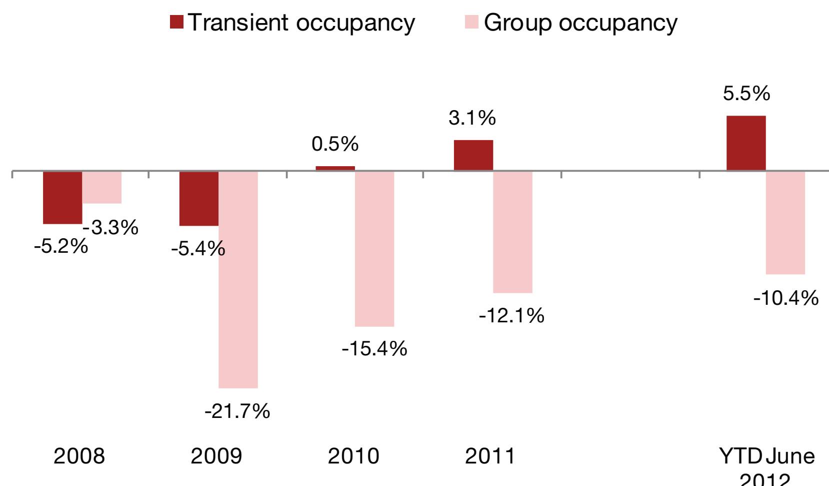
2. *Growth in room supply, as hotel inventory increased an average of 8.2% in the Top 25 markets between December 2007 and June 2012*. In aggregate, this is in line with the increase in supply across all US markets; however, some Top 25 markets have experienced substantial double-digit increases in supply since 2007, restraining the recovery of RevPAR. For example, lodging supply in New York, Houston, Phoenix, Miami and Washington, DC increased by more than 10% since December 2007.

Chart 2– Top 25 Markets RevPAR, Percentage difference between 2007 and 2011



Source: PwC, based on Smith Travel Research

Chart 3– Top 25 Markets Transient and Group Occupancy, Percentage difference relative to 2007



Source: PwC, based on Smith Travel Research

The combination of the above factors, combined with market-specific demand characteristics, has inhibited RevPAR recovery in at least 10 of the Top 25 markets, leaving room for continued recovery. The 10 markets in which 2011 RevPAR levels were significantly below the 2007 peak (Phoenix, San Diego, Atlanta, Chicago, Norfolk-Virginia Beach, New York, Orlando, Tampa-St. Petersburg, Seattle and Houston), have either experienced substantial supply increases or have a greater reliance on group travel and are suffering from continued sluggishness in group activity (see Table 1). Overall, 2011 RevPAR levels were below the 2007 level in 20 of the Top 25 markets. However, over the past six months, operating performance of hotels in some markets has recovered at a stronger pace. As a result, as of June 2012, only 15 of the Top 25 markets had RevPAR levels that were below the levels during the first half of 2007, partly closing the gap.

Table 1– Top 25 Markets RevPAR Recovery Characteristics

Market	Percentage difference between 2007 and 2011 RevPAR levels	Supply increase between December 2007 and June 2012	Contribution of group occupancy to overall occupancy in 2011	Percentage difference between 2011 and 2007 group occupancy levels
Phoenix, AZ	-25.0%	16%	45%	-21%
San Diego, CA	-14.4%	6%	40%	-17%
Atlanta, GA	-14.0%	2%	42%	-17%
Chicago, IL	-13.4%	6%	40%	-16%
Norfolk-Virginia Beach, VA	-13.2%	4%	35%	-13%
New York, NY	-11.7%	25%	19%	-7%
Orlando, FL	-11.6%	6%	46%	-24%
Tampa-St Petersburg, FL	-11.0%	6%	34%	-16%
Seattle, WA	-9.6%	9%	30%	-2%
Houston, TX	-9.3%	18%	29%	-15%
Anaheim-Santa Ana, CA	-8.6%	3%	31%	-15%
Dallas, TX	-8.5%	8%	40%	-10%
Philadelphia, PA-NJ	-7.8%	8%	35%	-16%
Detroit, MI	-7.3%	2%	30%	-19%
Minneapolis-St Paul, MN-WI	-5.5%	6%	35%	-9%
St Louis, MO-IL	-5.2%	7%	39%	-8%
Washington, DC-MD-VA	-4.7%	13%	41%	-4%
Los Angeles-Long Beach, CA	-4.3%	5%	24%	-7%
Nashville, TN	-3.0%	7%	52%	-19%
Denver, CO	-2.3%	7%	42%	-7%
Miami-Hialeah, FL	0.8%	16%	28%	-14%
Boston, MA	1.3%	3%	32%	-6%
Honolulu (Oahu Island), HI	3.2%	0%	10%	-44%
New Orleans, LA	6.8%	10%	43%	-6%
San Francisco/San Mateo, CA	10.0%	3%	29%	-4%

Markets are sorted by percentage change in RevPAR between 2007 and 2011.
Group occupancy information is for hotels in upper-tier hotels (Luxury, Upper Upscale and Upper-tier Independents) in respective markets.

Source: PwC, based on Smith Travel Research

Looking ahead, there are indications that there is room for continued recovery in the Top 25 markets, as the pace of supply growth slows and group travel recovery strengthens. According to PwC's recently released lodging outlook, RevPAR for US hotels is expected to increase by 7.2% in 2012,[1] which is an improvement over our prior outlook for 6.5% growth. This improvement in our RevPAR outlook is driven by recent gains in lodging performance, coupled with indications of year-over-year improvements in bookings currently in place for the balance of the year, including a greater volume of group bookings for meetings and other events. While hotels across the spectrum of price tiers are expected to benefit from this recovery, hotels in the higher-priced segments ˜ more than half of which are located in the Top 25 markets ˜ are expected to experience the strongest gains.[2] Occupancy levels at hotels in the luxury, upper-upscale and upscale segments are expected to meet or exceed each segment's 2007 peak, driving a stronger pace of price recovery.

Overall, while group travel is still below peak in most markets, the recovery of transient demand and slower pace of new hotel openings sets a context for improved pricing. This is expected to help lift some of the weaker Top 25 markets, while positioning leading markets such as San Francisco and Honolulu to set new highs.

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1 Based on PwC Hospitality Directions US Q2 2012 released on August 28, 2012 and can be accessed at http://www.pwc.com/us/en/asset-management/hospitality-leisure/publications/index.jhtml.

2 Calculation based on existing hotels information from Smith Travel Research as of March 2012. Overall, there are approximately 1.2 million hotel rooms in the Luxury, Upper Upscale and Upscale chain scale segments in the US. Of these, approximately 663,500 rooms, or approximately 54%, are located in the Top 25 markets.

The impact of FATCA withholding on real estate funds, real estate companies and real estate joint ventures

Part 1: US entities

By James Guiry and Adam Feuerstein

Introduction

The US Internal Revenue Service released proposed regulations under the Foreign Account Tax Compliance Act ("FATCA") related to withholding and reporting.[1] These rules can have a significant impact on entities that invest in US real estate. The rules are complex, and, while not all questions have been answered, it is clear that the withholding and reporting process will be far more complicated going forward.

Although real estate entities often have complex international structures with investments and investors that cross the US border, there are different concerns and considerations with respect to FATCA withholding and reporting as it relates to US and non-US entities. Therefore, we will issue two alerts on FATCA withholding and reporting. This alert focuses on US entities and their obligations under the new FATCA withholding and reporting regime. Another alert will be published in the near future focusing on the issues that non-US entities will need to face.

FATCA withholding and reporting: Why does it matter?

Withholding and reporting can seem a tedious process. It normally takes a back seat in tax discussions, which focus on the ultimate tax owed, instead of the withholding and reporting that is required to occur along the way. However, failure to comply with the FATCA withholding and reporting regime can have significant consequences. Most apparent, failure to properly withhold can subject an entity to liability for the amount it should have withheld, as well as interest and penalties. Aside from the tax cost, a failure to properly withhold can have a significant impact on a company's financial statements. In addition, a company that intends to enter into a significant transaction may be subject to outside due diligence in which the other party to the transaction will insist on compliance with FATCA (or utilize instances where there was a failure to withhold in its negotiations). The IRS has elevated withholding to its top tier of issues on which auditors should focus. As you

1 This article was submitted for publication prior to the promulgation of final FATCA regulations. It is unclear if the final regulations will be released prior to the publication of this article.

would expect, we have noticed an increase in audit activity with respect to withholding generally and as a result have noted an increase in the effort devoted to withholding diligence in connection with significant transactions.

Another important factor for US entities to consider is how non-US investors might react to FATCA withholding and reporting. Some non-US entities that hold interests in US entities will be required to enter into an agreement with the IRS and undertake additional diligence, withholding and reporting obligations with respect to their investors when they invest in US entities (or, alternatively, be subject to FATCA withholding at a rate of 30%). US entities should consider how their investors may respond to FATCA.

How does FATCA change how withholding and reporting is done?

While it is not practical to provide details in this alert on all of the changes that are brought about by FATCA in the 388 pages of proposed regulations and commentary from the IRS, we would like to highlight two important consequences of the proposed FATCA regulations that all US entities will need to consider when they make payments to non-US persons.

FATCA will subject more payments to US withholding tax and information reporting

More types of payments are subject to withholding and reporting under FATCA than have previously been subject to withholding and reporting under other US tax rules. Prior to FATCA, US entities were concerned with withholding and reporting on:

- Fixed or determinable annual and periodic ("FDAP") income (such as US Source dividends, interest, and rents);
- Income allocated to foreign partners from activities effectively connected with a US trade or business (such as income from an active real estate business), otherwise known as effectively connected income ("ECI"); and
- Payments associated with the disposition of a US real property interest, which are subject to withholding under the Foreign Investment in Real Property Tax Act ("FIRPTA").

With the advent of FATCA, US entities will need to be concerned with the application of FATCA withholding and reporting to FDAP as well as its application to gross proceeds associated with the disposition of assets that produce US source interest and dividends.

Payments that might be subject to FATCA withholding and reporting, but generally were not subject to withholding and reporting before FATCA, include:

- The repayment of principal on a note; and
- With respect to the stock in a US corporation (even if gain on the sale of its shares would not be subject to FIRPTA)
  - Proceeds from the sale of stock, or
  - Distributions to shareholders that are not treated as dividend distributions.

Therefore, US entities will need to consider a broader range of payments that may be subject to FATCA withholding and reporting rules and establish mechanisms to ensure that these rules are taken into consideration when they make such payments.

In addition, many of the exemptions that might apply to FDAP income do not apply in the FATCA context. For example, while payments of portfolio interest might not be subject to FDAP withholding and reporting, such payments would still be subject to the FATCA withholding and reporting regime.

While FATCA will cause US entities to consider a wider variety of payments for potential withholding, there are

some important exceptions to FATCA applicable to US entities. For example, payments in the ordinary course of business for non-financial services, goods or the use of property are generally not subject to FATCA withholding or reporting. Therefore, to the extent that a US entity pays for consulting or design services performed by a non-US entity, FATCA generally would not apply to that payment. However, these payments may still be subject to the current FDAP withholding and reporting regime.

FATCA withholding and reporting will be more complicated than the current withholding and reporting regimes

The new FATCA withholding and reporting rules are exponentially more complicated than the currently applicable rules. In part, this is simply because FATCA does not replace the old withholding and reporting regime. Instead, it is an additional regime, coordinated with the current withholding and reporting regimes with the intent to avoid double withholding.

However, even if FATCA was a stand-alone regime, the process of determining whether a payee is subject to withholding and information reporting would nevertheless be far more complex than the current withholding and reporting regimes. Non-US entities have been working with the IRS since the FATCA legislation was adopted in order to reduce the compliance burden of entities that are not likely to be used as vehicles for US tax evasion (which is the target of the FATCA rules). As a result, the Proposed Regulations provide exceptions to reduce the compliance burdens of different types of non-US entities. While the creation of these exceptions may be beneficial to the non-US entity that can qualify for the exception, it will be up to the US payor to make sure that it obtains and evaluates the appropriate documentation to confirm that the payee qualifies for an exception. In some cases, the process will require reviewing a Form W-8, often in conjunction with cross-checking a new FFI-EIN number provided by the payee with an IRS database to confirm that the payee qualifies for a withholding exemption. In other cases, determining whether a payee qualifies for an exception may require the payor to review an entity's organization documents, financial statements, legal opinions, or other information regarding the entity's classification under FATCA. Further, in some cases, US entities withholding under FATCA may have to look through the payee to indirect owners further up the ownership chain, which could require looking at each beneficiary's information to determine if withholding is necessary.

In addition to the complexity that results from the different categories of non-US entities, the proposed FATCA regulations create additional administrative burdens by changing the presumption rules available to withholding agents for determining whether an entity is deemed to be a US person or a non-US person. For example, in the pre-FATCA world, withholding agents could often presume that a corporation was treated as a US person not subject to information reporting without obtaining a Form W-9 certifying that the corporation was a US person. Conversely, the proposed FATCA regulations indicate that a withholding agent must generally presume that a corporation is a non-US person if it does not have proper documentation indicating otherwise. Further, the preamble to the proposed regulations indicates that this new presumption for FATCA is expected to be implemented for other areas of information reporting and withholding. Therefore, US payors that have been presuming that their corporate payees are US persons (as opposed to obtaining a Form W-9) may now need to obtain a Form W-9 from each entity payee. In addition, from the payee's perspective, US corporations that have not provided a Form W-9 in the past may need to do so to prevent payments to them from FATCA withholding (and other withholding regimes as well if the conforming changes referenced in the preamble to the proposed FATCA regulations are implemented).

How does FATCA withholding interact with the other withholding regimes?

Currently, US entities are concerned with withholding of income treated as FDAP and ECI (including income subject to FIRPTA). However, while FATCA withholding is broader and covers more types of payments than those regimes, there is a lot of overlap with payments covered by FATCA and the other regimes. The proposed regulations under FATCA provide guidance regarding how the FATCA regime interacts with the other regimes.

As a general matter, there are four types of payments in the pre-FATCA withholding world: (i) FDAP income subject to withholding, (ii) payments subject to ECI withholding, (iii) payments subject to FIRPTA withholding and (iv) payments not subject to FDAP, ECI, or FIRPTA withholding. For purposes of the FATCA coordination rules, if an entity (e.g., a REIT) has a choice regarding whether it treats a distribution as FDAP or FIRPTA distribution, that choice will govern which coordination rule applies.

Payments not subject to FDAP, ECI, or FIRPTA withholding and reporting are, not surprisingly, subject to FATCA withholding and reporting to the extent they are FATCA withholdable payments.

Payments currently subject to FDAP withholding and reporting that are also subject to FATCA withholding and reporting will be subject to both regimes. If withholding is actually required under FATCA, that amount will reduce (and generally eliminate) the amount actually withheld under FDAP. However, the payments will still need to be reported under both regimes.

Payments currently subject to ECI and FIRPTA withholding will not be subject to withholding under FATCA. However, this appears only to apply to payments that are actually subject to ECI or FIRPTA withholding. For example, if a payment is exempt from FIRPTA withholding because it is attributable to the acquisition of an interest in a domestically controlled REIT, the payment of the proceeds would still be subject to reporting, and possibly withholding, under the FATCA regime even though no FIRPTA withholding would be required.

How do the FATCA rules apply to US partnerships?

While the general rules described above apply to partnerships, there are some special considerations that apply in connection with partnerships and payments to their partners. First, the timing for FATCA withholding on partners attributable to FDAP income received by the partnership refers to the rules for withholding on FDAP income. With respect to the timing of FATCA withholding on the receipt of gross proceeds attributable to the disposition of an asset that can generate US source interest or dividends, the proposed regulations reserved on this topic. Therefore, additional guidance will be needed before partnerships can determine when they will need to withhold on these payments.

Second, a partnership is currently required to withhold on income and payments with respect to all of its ECI (which includes income subject to FIRPTA) allocable to a foreign partner. This income will not be subject to withholding and reporting under FATCA to the extent it is actually subject to withholding and reporting under the current regime for withholding on partnership ECI.

There is also no guidance in the proposed FATCA regulations regarding how the sale of a partnership interest (or a transaction that reduces a partner's basis in its partnership interest) is treated for purposes of FATCA. It is not clear if this will be addressed by the final regulations.

What should US entities be doing now with respect to FATCA?

While it is important to take FATCA withholding seriously, and the withholding process will be significantly more complicated going forward, there is some time for US entities to make the changes needed to comply with FATCA withholding. The withholding provisions begin to apply in 2014, and the proposed regulations provide a variety of rules meant to make the transition easier.

Still, while there is some time to prepare for FATCA withholding, there are steps that all US entities should be taking at this point. In particular, each US entity should develop a plan and timetable to make sure that it takes the steps needed to be ready to withhold the appropriate amounts in 2014. As part of that process, each US entity should look to its investor base to determine what types of information it will need to obtain from each of its investors and develop a plan to obtain the needed information. In addition, each US entity should examine the types of payments it makes to investors to determine what additional procedures might need to be in place to ensure that FATCA withholding is taken into account when these payments are made.

To the extent that a new US entity is being formed (such as a new real estate fund), or a new arrangement is being entered into, the new entity should consider what additional information should be obtained from its investors at the time of subscription, or what information might need to be obtained in the future, and take those into account in connection with information it collects and provisions that might need to be included for subscription or other agreements.

As part of this process, US entities will want to consider how this affects their relationships with their non-US investors. The issues that will need to be considered with respect to FATCA withholding include:

- Identifying internal and external teams to address FATCA;
- Training people internally;
- Determining what information should be provided to current non-US investors regarding FATCA withholding;
- Determining how to get any needed information from non-US investors;
- Addressing concerns of non-US investors;
- Considering whether additional disclosure is required with respect to new entities created in connection
- Considering whether any restrictions should be placed on the types of investors that the US entity has in order to lessen its FATCA withholding burden.

Conclusion

FATCA withholding is an important change with respect to payments to non-US entities and will have a significant impact on the withholding process. While there is time for US entities to consider how they will address the new FATCA withholding rules, it is important that US entities with non-US investors take the new rules seriously and develop a plan to make sure the US entity is in a position to satisfy the new rules as they become effective.

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The impact of FATCA withholding on real estate funds, real estate companies and real estate joint ventures

Part 2: Non-US entity classification

By James Guiry and Adam Feuerstein

Introduction

This is the second client alert we are issuing regarding the implications for real estate companies, funds and joint ventures in connection with the proposed regulations related to the due diligence, withholding, reporting and certification obligations under Internal Revenue Code Sections 1471-1474 (commonly referred to as the Foreign Account Tax Compliance Act ("FATCA")). While the first alert focused on US entities and their obligations under FATCA, this alert focuses on the classification of non-US entities under FATCA and the steps that non-US entities should be taking with respect to complying with this new regime (which, is in addition to, and does not replace other US information reporting and withholding regimes).

FATCA withholding: Why it matters to non-US real estate entities

Unless a non-US entity is able to qualify for an exemption or comply with FATCA's requirements, US source FDAP income paid to that non-US entity generally will be subject to 30% withholding ("FATCA Withholding") starting on January 1, 2014. On January 1, 2015, the payments subject to FATCA withholding will be expanded to include gross proceeds from the sale or disposition of a property which can produce US source interest and dividends (previously gross proceeds paid to non-US persons were not subject to any withholding, except in limited situations such as proceeds attributable to the disposition of a US real property interests subject to the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")). While FATCA withholding is not set to commence until 2014, an entity that does qualify for an exception will need to consider, plan and implement the appropriate due diligence, withholding, reporting and certification requirements well before that date in order to avoid any FATCA withholding.

Payments subject to withholding: Broad scope

Through a phased approach, FATCA withholding begins in 2014 and 2015 and applies to "withholdable payments" which includes both US source fixed and determinable annual or periodic income (which includes rent, interest and dividends) and proceeds from the sale or disposition of property that produce US source interest or dividends. Withholding on withholdable payments applies even if

the payment generally would not be subject to other US withholding regimes. Examples of payments to non-US persons which may be subject to FATCA withholding but generally were not subject to withholding previously (if proper documentation was provided) include:

- Income that qualifies for the portfolio interest exemption;
- Income that would be subject to no withholding (or a lower rate) under a treaty;
- Proceeds from the sale of stock of an entity that is not a US real property holding corporation;
- Proceeds from the sale of stock of a domestically controlled REIT or other stock of a US real property holding corporation if the sale would otherwise be exempt from the FIRPTA withholding regime;
- Repayment of the principal on a note issued by a US entity; and
- Distributions from a US corporation that are not dividend distributions.

Moreover, certain payments received from non-US persons (foreign passthru payments) are currently scheduled to be subject to FATCA withholding beginning no earlier than 2017. The proposed regulations reserved the definition of foreign passthru payments for future guidance. However, previous guidance noted that this could include non-US source payments from a non-US corporation if a portion of the payment is treated as attributable to a US source withholdable payment received by the non-US corporation. While it remains unclear in which circumstances a non-US entity will need to be concerned about payments the non-US entity receives from non-US sources, a non-US entity must undertake certain diligence obligations with respect to its investors. Therefore, FATCA classification may also be relevant for investments in non-US corporations.

Importance of FATCA classification for non-US real estate entities

The due diligence, reporting, withholding and certification requirements under FATCA differ depending on the non-US entity's FATCA classification. At one end of the spectrum, certain entities will only need to certify their status to the payee on a Form W-8 (or equivalent), while at the other end of the spectrum, other entities will be required to enter into agreements with the IRS and comply with all of the provisions therein ("FFI agreement"). There are dozens of different classifications that may apply, however it is helpful to think of three broad classifications: (i) foreign financial institution ("FFIs"), (ii) non-financial foreign entities ("NFFE"), and (iii) exempt beneficial owners.

FFIs

Under the proposed regulations, a non-US entity will be an FFI if the entity:

- Accepts deposits in the ordinary course of a banking or similar business;
- Holds assets, as a substantial portion of its business, for the account of others;
- Is an insurance company (or the holding company of an insurance company) that issues or is obligated to make payments with respect to a financial account (as defined in the regulations); or
- Is engaged (or holds itself out as engaged) primarily in the business of investing, reinvesting or trading in securities, partnership interests and other financial instruments listed in the proposed regulations.

Entities in the real estate sector likely would be most affected by the last FFI category, which is referred to herein as an Investment FFI. Under the proposed regulations, an entity will be an Investment FFI if 50% or more of its gross income is attributable to investing, reinvesting and trading securities, partnership interests and other listed financial instruments over a three year period (or the period during which the entity has been in existence).

Because the test for the last FFI category is based on investment in securities, partnership interests and certain other financial instruments, an entity that directly holds only real estate generally would not be treated as an FFI because real estate is not treated as a security. However, investments in US real estate by non-US persons are often made through an entity treated as a corporation (including a REIT) for US tax purposes. Therefore, as a practical matter, the fact that an entity that invests directly in US real estate would not be treated as an FFI may have limited relevance in practice. Still, some non-US entities that invest in US real estate may have significant investments

in non-US real estate that are made directly or through entities that are disregarded as separate from their owner for US tax purposes. If the income derived from a non-US entity's investments in real estate through disregarded entities exceeds the income derived from investments made through entities treated as partnerships or corporations for US tax purposes, then the non-US entity generally would not be treated as an FFI.

It is interesting to note that under the proposed regulations a non-US entity will be treated as an Investment FFI only if 50% or more of its gross income is from "investing." It is unclear whether there are circumstances in which income may be derived from subsidiaries, but not be treated as derived from "investing." For example, if a real estate fund holds an investment through a subsidiary, income derived from that subsidiary would almost certainly be treated as derived from "investing." However, it is unclear whether the income derived by a real estate operating company from a wholly owned subsidiary would be treated as being derived from "investing."

This raises a concern for real estate (and other) operating companies. Unless the IRS provides guidance indicating that income from a subsidiary will not be treated as from "investing," if an operating company holds one or more subsidiaries, and if 50% or more of the income of the operating company is comprised of dividends received from the subsidiaries, the operating company may be treated as an FFI even though operating companies were not the target of the rules applicable to FFIs.

Classification of FFIs

Once it has been determined that an entity is an FFI, the entity will need to determine whether it can qualify as an excepted FFI or a deemed compliant FFI. If an FFI cannot satisfy either of those categories it must decide to become a participating FFI or it will be a non-participating FFI. In general, withholdable payments to a nonparticipating FFI may be subject to FATCA withholding while payments to a participating FFI, excepted FFI or a deemed compliant FFI generally are not subject to FATCA withholding (unless the payee is required to look through to the owners of the FFI (i.e. in a partnership or similar flow through vehicle) and the owners of the FFI are subject to FATCA withholding).

The key distinction between a participating FFI, on the one hand, and a deemed compliant FFI or an excepted FFI, on the other, is that a participating FFI is required to enter into an agreement with the IRS, which will not only require the entity to perform a high level of diligence with respect to its investors, but also FATCA withholding and reporting and more extensive certifications, whereas the requirements of a deemed compliant FFI and an excepted FFI generally are less burdensome. The requirements of an excepted FFI are generally less burdensome than the requirements of a deemed compliant FFI.

Requirements for participating FFIs

In general, a participating FFI must enter into an FFI agreement in order to mitigate FATCA withholding. While a draft of the FFI agreement has not been released, the proposed regulations do provide some insight regarding some of the responsibilities of a participating FFI under an FFI agreement. These obligations generally relate to account holders, which in the case of an FFI that is a real estate fund or another type of real estate investment entity generally would include many holders of debt or equity in the fund or entity. These obligations are expected to include:

- Applying FATCA withholding on certain payments to account holders to the extent they are made to nonparticipating FFIs, or account holders that do not provide the documentation required under FATCA, or to certain payees that make an election for the withholding agent to withhold certain amounts.
- Performing specified due diligence and certification procedures to identify and document each account holder. Although this alert does not explore the diligence procedures in the proposed regulations in detail, among the due diligence requirements is that a participating FFI will be required to perform an electronic review of information and documentation received by individuals that own financial accounts to determine if an indication of potential US ownership exists with an enhanced review of accounts with a value in excess of $1,000,000.
- Reporting with respect to non participating FFIs, recalcitrant account holders and US accounts.
- Obtaining a waiver with respect to any local law that would prevent providing the information required under FATCA directly to the IRS.

- Adopting written policies and procedures governing its due diligence procedures for complying with FATCA and periodically certifying compliance with these policies.

Excepted FFIs

Certain entities, that otherwise might be treated as FFIs, are excepted FFIs and will not have to provide information about their investors to avoid FATCA withholding. Instead, these entities will provide a Form W-8 certifying their status. The applicability of these exceptions is somewhat limited as described in more detail below.

Non-financial holding companies

In order for an entity to satisfy the rules in the proposed regulations related to non-financial holding companies, which are excepted from the rules generally applicable to both FFIs and NFFEs, the entity must operate as a holding company for a subsidiary or group of subsidiaries that primarily engage in a trade or business other than that of a financial institution. Therefore, the exception is not available to an investment vehicle whose purpose is to acquire or fund companies and then hold the interests in those companies as capital assets for investment purposes. Consequently, the exception is not available to a non-US real estate investment fund that holds all of its real estate investments through subsidiaries. However, it is not clear when a real estate operating business that holds subsidiaries would be treated as holding the subsidiaries as capital assets for investment purposes. If the operating company was treated as holding the subsidiaries for investment purposes, then it would not be able to take advantage of this exception.

Even if a real estate operating company was treated as holding its subsidiaries for non-investment purposes, the holding of those subsidiaries must comprise substantially all of the company's activities. Therefore, a company which has subsidiaries but also has its own business (or has a business conducted through a disregarded entity) would not appear to be able to satisfy this exception.

As the exception only applies if the subsidiaries engage in a non-financial trade or business, the non-US entity will first need to determine whether the activities of the subsidiaries are treated as a trade or business. Therefore, the non-US entity will need to examine the real estate (and other) activities of the subsidiaries to determine if the activities constitute a trade or businesses. Often, this will not be a simple analysis.

It is also unclear whether a subsidiary would be treated as engaged in a trade or business if it did not engage in a trade or business directly, but held an interest in a subsidiary which engaged in a trade or business. Therefore, it is not clear if a non-US entity could satisfy the holding company exception even if it held all of its interests through subsidiaries if those subsidiaries held interests in other entities (even if each of those other entities are engaged in a trade or business).

Other entities not subject to the requirements applicable to FFIs and NFFEs

Other types of entities that are excepted FFIs include certain (i) entities described under Section 501(c) of the Internal Revenue Code (which describes certain entities, such as charities, exempt from US taxation), (ii) non-financial businesses during their start-up phase, (iii) non-financial entities that are liquidating or emerging from bankruptcy and (iv) hedging centers of a non-financial group. The start-up entity exception will only apply during the first 2 years of existence.

Deemed compliant FFIs

Certain FFIs will be treated as a deemed compliant FFI and will not need to enter into an FFI agreement. As will be readily apparent, treatment as a deemed compliant FFI is only available in certain limited cases.

Owner documented FFIs

Owner documented FFIs are FFIs that, among other things, provide information about their owners to a US financial institution or a participating FFI from whom the FFI receives a payment subject to withholding. The payer would then withhold amounts from the owner documented FFI based on the information provided about the owner documented FFI's owners. Unlike other classifications under FATCA which apply to an entity in connection with all of its investments, an entity may be an owner documented FFI with respect to some investments, but not others.

This classification is likely to be particularly relevant to FFIs that do not want to enter into an FFI agreement with the IRS and are investing in entities, or are investing through custodians, that would be willing to assume the withholding obligations for their investors. However, as noted above, the FFI would be required to provide information about its direct and indirect owners to the entity in which it is investing in order to be treated as a deemed compliant FFI.

As a practical matter, many investors that have a particular classification under FATCA may need to utilize the owner documented FFI provisions as well when they do not make an investment directly. For example, under the proposed regulations, if a non-US entity that is a retirement fund that qualifies as a deemed compliant FFI invests in a US fund or a non-US fund, but does so indirectly through an entity that is regarded for US income tax purposes, the entity through which it invests is not likely to qualify as a retirement fund itself. However, the entity that makes the investment could be treated as an owner documented FFI and could provide information about the retirement fund to the withholding agent indicating that no withholding is required.

Note that the owner documented FFI classification is only available with respect to amounts received from a US financial institution or a participating FFI. Therefore, whether the owner documented FFI classification is available will depend on whether the entity directly invests in, or receives a payment from, either a US financial institution or a participating FFI. This can lead to some surprising results.

For example, if a non-US entity invests in a US partnership that only holds interests in a REIT, the US partnership would be a US financial institution (because more than 50% of its income would be derived from dividends which presumably would be treated as from investing in securities) and it may be possible for the FFI to be an owner documented FFI. In that case, the non-US entity would not need to enter into an FFI agreement or adopt specific diligence procedures. Instead, it would provide information about its owners to the US partnership and the US partnership, would withhold as appropriate.

However, if the non-US entity invested directly in a REIT which holds all of its real estate through wholly owned LLCs, the REIT would not be a financial institution (as explained above, if it is treated as holding only real estate it would not be treated as an FFI) and the non-US entity would not be able to be an owner documented FFI and, unless another exception applied, would be required to enter into and comply with an FFI agreement to avoid FATCA withholding. It is possible that limiting the availability of owner documented FFI treatment to payments received from financial institutions was not intentional and may be remedied in the final regulations or other future guidance.

There are several other important requirements that must be satisfied to qualify as an owner documented FFI.

- The withholding agent must agree to undertake this responsibility. Therefore, as noted above, a non US entity may be an owner documented FFI with respect to payments received from some persons, but not others.
- This classification is not available to an entity if the entity or its affiliates can be classified as an FFI because the entity accepts deposits, holds assets on the account of others or is an insurance company.
- This classification is available only if the FFI does not have any account holders that are non-participating FFIs and the FFI does not issue debt to an account holder in excess of $50,000. An account holder for this purpose may include a holder of a debt or equity interest.
- To become an owner documented FFI with respect to a particular withholding agent, a non-US entity will have to annually provide to the withholding agent either certain information and documentation about its owners or provide an auditor's letter from a firm with a location in the United States.
  - A non-US entity that satisfies this requirement by providing information and documentation will need to provide: (i) the name, address, TIN, and entity classification for every person that owns an interest in the entity, (ii) the percentage owned, and (iii) any other information that is reasonably requested by the withholding agent to fulfill its withholding obligations. The entity will also be required to provide certain documentation regarding certain investors that hold an interest, directly or indirectly, in the non-US entity.
  - A non-US entity that satisfies this requirement with an auditor's letter will need to provide a letter signed by a US accounting firm or legal representative indicating that the auditor has reviewed the information about the owners of the FFI and that certifies that the non-US entity meets certain requirements outlined in the FATCA regulations.

Retirement funds

As discussed below, certain retirement funds are exempt beneficial owners that are exempt from the requirements generally applicable to both FFIs and NFFEs. However, even if a retirement fund is not treated as an exempt beneficial owner, it may still qualify as a

deemed compliant FFI (which would obviate the need to become a fully participating FFI to avoid FATCA withholding). For a retirement fund to be treated as a deemed compliant FFI, the entity must be organized for the provision of retirement or pension benefits under the laws of the country in which it is established or in which it operates and it must satisfy one of the following two tests.

Test One – (i) all contributions to the retirement fund must be employer, government or employee contributions that are limited by reference to earned income, (ii) no single beneficiary can have the right to more than 5% of the retirement fund's assets and (iii) either (a) contributions that would otherwise be subject to tax in that jurisdiction are excluded from the gross income of the beneficiary, (b) the taxation of income attributable to the beneficiary is deferred under the laws of the jurisdiction, or (c) 50 percent or more of the total contributions to the FFI are from the government or the employer.

Test Two – (i) the retirement fund must have fewer than 20 participants, (ii) the retirement fund must be sponsored by an employer (other than certain employers that are FFIs, including a real estate fund), (iii) contributions to the retirement fund must be limited by reference to earned income, (iv) participants that are not residents of the country in which the retirement fund was organized may be entitled to no more than 20% of the retirement fund's assets and (iv) no participant that is a resident of a country other than the country in which the retirement fund FFI is organized may be entitled to more than $250,000 of the retirement fund's assets.

Other deemed compliant FFIs

Other deemed complaint FFIs include non-profit organizations, non-reporting members of FFI groups, qualified collective investment vehicles, restricted funds, local FFIs, nonregistering local banks and FFIs with low value accounts. The requirements for each of these deemed complaint FFIs can be found in the Schedule attached to this alert.

NFFEs

The classification of an NFFE is relatively straightforward as they are simply non-US entities that are not FFIs. The requirements of an NFFE are less burdensome than the requirements applicable to participating FFIs as NFFEs do not need to enter into agreements with the IRS, and there are no specified diligence requirements applicable to an NFFE. However, an NFFE will be required to identify US owners (subject to certain exceptions) that own more than 10%, directly or indirectly, of the NFFE or certify that it has no such owners. Therefore, it will need to obtain sufficient information from its direct and indirect owners to be able to make such a certification.

Certain NFFEs may be eligible for an exception from the certification requirements applicable to NFFEs. Exceptions available for NFFEs may be available for (i) publicly traded companies and their affiliates, (ii) certain entities organized in US possessions (iii) active NFFEs, (iv) exempt beneficial owners and (v) excepted FFIs. It is important to note that (i), (ii) and (iii) only apply to NFFEs and do not apply to an entity classified as an FFI. For example, a publicly traded corporation that is an FFI generally is not excepted from FATCA withholding as a result of its publicly traded status.

An NFFE is an active NFFE if less than 50% of its gross income is passive income and less than 50% of its assets are assets that produce or are held for the production of passive assets. Passive income includes, among other things, interest, dividends and passive rents. Passive rents are rents other than those derived in an active trade or business conducted by employees of the NFFE. Therefore, if the entity does not have employees, its rental income will be passive in nature. Still, certain entities that conduct active real estate activities through its employees may be treated as active NFFEs.

Exempt beneficial owners

Entities that are classified as exempt beneficial owners generally have little compliance responsibilities with respect to FATCA withholding, reporting and due diligence and generally will be required to only provide a Form W-8 to a withholding agent to certify their status in order to avoid FATCA withholding. While there are a number of entities that fall within this category, these classifications are unfortunately narrow in scope. While some of these classifications may be helpful to certain classes of non-US investors in real estate, they are not generally applicable to real estate related funds, companies and joint ventures themselves.

Foreign governments and other non-US governmental entities

The following entities qualify as exempt beneficial owners under the proposed regulations and are not subject to the rules that generally apply to FFIs or NFFEs:

- Foreign governments;
- Governing authorities of a foreign sovereign (provided the net earnings do not inure to the benefit of any private person);
- Wholly owned entities of a foreign sovereign (provided the net earnings do not inure to the benefit of any private person);
- Governments of US possessions;
- International organizations; and
- Foreign central banks of issue.

It is interesting to note (in particular, for real estate entities that have foreign government investors and joint venture partners) that the exception from FATCA withholding for entities wholly owned by a foreign sovereign may apply to certain entities, even if the entity is not treated as part of a foreign sovereign for purposes of Section 892 of the Code (which generally exempts non-commercial income earned by foreign governments from US income taxation). For example, an entity that is organized outside of the home country of a foreign government is not eligible for the exemption in Code Section 892, but could be exempt from FATCA.

In addition, while a wholly owned entity that engages in commercial activity would not be eligible for the exemption in Code Section 892, such an entity generally would not be subject to FATCA withholding. However, under the proposed regulations a wholly owned entity that accepts deposits in the ordinary course of a banking or similar business or holds accounts for the benefit of others as a substantial part of its business (such as a broker/dealer) may not be eligible for this exception.

Retirement funds

Under the proposed regulations, certain retirement funds can also be classified as exempt beneficial owners provided the retirement fund is the beneficial owner of the payment received and the retirement fund meets all of the requirements under either of the following two tests (as noted above, retirement funds that do not satisfy these tests, and therefore are not exempt beneficial owners, may still be deemed compliant FFIs as described above):

Test One – The retirement fund is: (i) established in a country with a US tax treaty in force, (ii) exempted, in general, from income taxation in the country in which it is established, (iii) operated principally to administer or provide pension or retirement benefits and (iv) entitled to benefits under the US income tax treaty with respect to income from US sources as a resident of the other country that satisfies any applicable limitation on benefits requirement.

Test Two – The retirement fund: (i) is formed for the provision of retirement or pension benefits under the laws of the country in which it was established, (ii) receives all of its contributions from government, employer and employee contributions that are limited by reference to earned income or from certain transfers of assets, (iii) does not have a beneficiary entitled to more than five percent of the entity's assets and (iv) either is exempt from tax in the country in which it is established or operates or receives more than 50% of its total contributions from the government or employers.

State of flux

It is important to note that the classifications described above, and the requirements associated with them, are still in somewhat of a fluid state. The Treasury and the IRS have received a number of comment letters since the publication of the proposed regulations and the FATCA classifications that have been described above may be revised by either the final regulations or other future guidance. There also may be additional classifications in the final regulations.

The United States is currently negotiating FATCA agreements with other countries which may create new classifications of entities that will be specific to a particular country. The agreements with other countries may also provide that entities described above may be able to satisfy the FATCA requirements in ways not outlined in the proposed regulations. For example, it is expected that certain entities will be able to provide information to their own government, in lieu of reporting the information directly to the IRS. While the US has released model agreements, no agreements have been entered into.

Action items for non-US entities

Organizations that have one or more non-US entities in their organizational structures should begin considering the implications of FATCA withholding on each of their non-US entities. While FATCA withholding will not begin until 2014, non-US entities that intend to be participating FFIs may submit their FFI applications prior to January 1, 2013. The IRS has indicated that entities that submit applications prior to June 30, 2013 will be considered participating FFIs by January 2014. Therefore, entities that desire to be treated as participating FFIs will want to submit their applications between January 1, 2013 and June 30, 2013. This will allow the participating FFIs to provide the necessary information to their withholding agents before withholding commences in 2014.

In addition, each organization should identify an internal team to address FATCA to ensure that individuals are empowered to take the appropriate steps so that its entities do not unexpectedly become subject to FATCA withholding. Once the team is identified, internal staff should be trained so that they know what FATCA implementation will involve and, to the extent needed, so that they can reach out to investors and other stakeholders to allay any fears or apprehensions over FATCA.

The FATCA team should take an inventory of all entities in the organizational structure and classify each entity into its appropriate FATCA category. As described above, FATCA classification is an important step to determine the burden that FATCA will place on the organization.

Assuming the organization will include at least one participating FFI, the FATCA team should also be responsible for ensuring that the organization is in a position to enter into, and comply with the provisions in, the FFI agreement. As part of this process, the FATCA team should identify gaps in existing information reporting and withholding processes and procedures and technology that will prevent FATCA compliance (e.g., inability to track gross proceeds).

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Deemed compliant entity criteria

Entity type	Criteria to meet designation
Local FFI	(1) Must be licensed as a bank, securities dealer, financial planner or advisor, (2) Must not qualify under (e)(1)(iii), primarily engaged in investing, (3) Must not have a fixed place of business or solicit accountholders outside its country of incorporation, (4) Must be required to perform information reporting or withholding on residents, (5) Must have at least 98% accountholders in country of organization (includes residents of other EU member states), (6) Must have policies and procedures not to open or maintain accounts for US persons, (7) Must complete due diligence on pre-existing accounts, and either (a) certify that no US accounts were identified, (b) certify that all identified accounts were closed, or (c) agree to withhold and report on identified US accounts), and (8) Each member of the EAG must be incorporated in the same country and qualify as a local FFI.
Low Value Accounts	(1) Must qualify as an FFI as a bank or custodial institution, (2) Must have no accounts which are in excess of $50,000 (if a member of an EAG, no member of the EAG may have an account in excess of $50,000), and (3) Must have no more than $50M in assets on its balance sheet (if a member of an EAG, the EAG must have no more than $50M in assets on its consolidated balance sheet).
Non-profit Organizations	(1) Must be organized exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, (2) Must be exempt from tax in its country of residence, (3) Must have no shareholders with a proprietary or beneficial interest in its income or assets, (4) Must not allow for distribution of income or assets to a private person or non-charitable FFI, other than pursuant to its charitable activities, and (5) Must, upon liquidation, be required to distribute its income or assets to a foreign government or another qualifying non-profit organization.
Non-registering Local Bank	(1) Must be licensed and operate solely as a bank in its country of operation, (2) Must have no fixed place of business outside of its country of organization, (3) Must not solicit accountholders outside of its country of organization, (4) Must have no more than $175M in assets on its balance sheet, (5) If a member of an EAG, the EAG must have no more than $500M in total assets on its consolidated balance sheet, (6) Must be required to perform information reporting or withholding on residents or if not required to perform information reporting and withholding, have no account with a value or account balance of %50,000 or more, and (7) If a member of an EAG, each member of the EAG must be incorporated in the same country and qualify as a non-registering local bank.
Non-reporting FFI in a Participating Group	(1) Must complete account due diligence, (2) Must, within 90 days, if any US accounts identified, (a) enter into an FFI agreement, (b) transfer the account to a participating FFI or US financial institution, or (c) close the account, and (3) Must implement policies and procedures to transfer accounts or register as an FFI within 90 days of opening a US account, or if a change in circumstances within an existing account creates a US account.
Owner documented	(1) Must not be (or be affiliated with) a bank, custodial institution, or insurance company, (2) Must not maintain an account for a non-participating FFI in excess of $50,000, (3) Must provide withholding agent all required documentation, and (4) The withholding agent must agree to report information on all US accountholders (direct or indirect) to the IRS.

Deemed compliant entity criteria

Entity type	Criteria to meet designation
Qualified Collective Investment Fund	(1) Must qualify under (e)(1)(iii), primarily engaged in investing, and be regulated as an investment fund in its country of organization, (2) Each debt holder in excess of $50,000 or equity holder must be a (a) participating FFI, (b) registered deemed-compliant FFI, (c) US person according to table 14, or (d) exempt beneficial owner, and (3) If a part of an EAG, all members of the EAG must be participating or registered deemed-compliant FFIs.
Restricted Fund	(1) Must qualify under (e)(1)(iii), primarily engaged in investing, be regulated as an investment fund in its country of organization, and be sold through qualifying distributors or redeemed directly by the fund, (2) Each distributor must be a participating FFI, registered deemed-compliant FFI, non-registered local bank, or a restricted distributor (collectively "qualifying distributor"), (3) Must ensure that distribution agreement prohibits sales to US persons, non-participating FFIs, or passive NFFEs with substantial US owners (4) Must require distributors to notify the fund of a change of its Chapter 4 status within 90 days, (5) If a distributor ceases to qualify under (2), Fund will (a) terminate its relationship with the distributor within 90 days, and (b) acquire or redeem all debt and equity interests issued through the distributor within 6 months, (6) Must implement policies and procedures that either the Fund (a) does not open or maintain accounts for holders defined in (3), or (b) will either (i) close any account held by holders defined in (3) within 90 days or (ii) withhold as a participating FFI, and (7) If a part of an EAG, all members of the EAG must be participating or registered deemed-compliant FFIs.
Retirement Funds	(1) Must be organized for the provision or retirement or pension benefits in its country of organization and either: (2) (a) all contributions are from employer, government, or employee, (b) all contributions are limited by reference to earned income, (c) no beneficiary has a right to more than 5% of the FFIs access, and (d) contributions are deductible or excluded from gross income, or (3) (a) has fewer than 20 participants, (b) is not sponsored by a FFI in the primary business of investing or a passive NFFE, (c) contributions are limited by reference to earned income, (d) non-resident participants are not entitled to more than 20 % of the FFIs assets, and (e) no non-resident is entitled to more than $250,000 of the FFIs assets.

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