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US Real Estate Insights

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Dear Clients and Friends,

On behalf of PwC's Real Estate Practice, it is our pleasure to offer another edition of US Real Estate Insights. This publication 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.

Recently, we debuted our global vision statement – to build trust and work toward solutions to the world's biggest problems. We always want to bring you thought leadership that is relevant to our industry, while also speaking to your topical needs related to accounting and financial trends and updates. We are seeking to be more than your accounting firm – we want to have a seat at your business table as a trusted advisor helping tackle your biggest needs.

We are especially pleased to offer an exciting piece on the "Office of the Future." As the "baby-boomers" reshaped housing trends, created suburbia and put station wagons and mini-vans on our interstate highway system, we are now seeing the Millennials (80 million strong) impact real estate trends in a meaningful way. One of those trends is the creation of new, efficient, collaborative and sustainable urban office venues. This innovative approach to office space layout and utilization is explored and discussed with insightful thoughts and observations.

In addition, we encourage you to read our flagship thought leadership piece, ***Real Estate 2020: Building the future***. As confidence returns to real estate, the industry faces a number of fundamental shifts that will shape its future. To help real estate managers and the investment community better plan, we have looked into the likely changes in the real estate landscape over the coming years and identified the key trends which, we believe, will have profound implications for real estate investment and development.

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.

Byron Carlock, Jr.
National Partner & Real Estate Practice Leader
byron.carlock.jr@us.pwc.com
(214) 754 7580

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Leveraging the physical workplace to manage risk

By Steven M. Adams

With so many competing business priorities, why should any business spend time and capital redesigning its physical workplace? Does the layout of the floors, the size of offices and workstations, the content of meeting rooms, the color of the paint and the comfort of chairs really make any real contribution to the bottom line or is workplace strategy a passing fad or consultant voodoo? Companies often use the rationale of reducing or avoiding costs as the justification for workplace redesign. After all, real estate is typically one of the top expenses for any business.

Based on our real world experience in transforming our own workplace, we feel an exclusively cost centric view is myopic. Redesigning the workplace with the sole goal of cutting or avoiding costs can undermine the real value of the workplace, its ability to help business manage significant risks of forthcoming trends.

Technology as the catalyst

Let's briefly revisit the past to illustrate how radically work has changed over the last two decades thanks to advancement in technology. In the early 1990s, the locations in which we could work were limited by two primary constraints; network access and portability of computers.

Knowledge workers had to come to the office and more specifically, to a certain desk because that is where their computer was located. The huge bulky PC tucked under the desk with an equally large monitor on top dictated, to a large degree, how and where work occurred.

Further limiting the choice of work location was access to the company network and the Internet. If one was fortunate to have a laptop and wanted to work in a location other than their desk, the need of a cabled network connection still imposed limits on the choice of environment. Work was limited by the location of a wall jack and the length of a network cable. Wireless technologies would eventually free us from this need but not until late 1999.

Fast forward to 2014, tower computers and bulky monitors are no longer seen in the office, wireless network access is ubiquitous, Apple is soon to release the 6th generation of the iPhone, tablets are soon expected to outsell laptops and the new buzzword is the Internet of Everything. Work has become fluid and dynamic. Wireless and cellular connectivity in conjunction with lightweight portable computing devices have fundamentally changed the definition and purpose of the office. Many of the physical spaces that were required just a decade ago are obsolete and new spaces are needed to support new ways of working. Work is no longer place centric.

What will change by 2020, six short years from now? Will desk phones no longer exist in favor of smartphones or softphones? Will walls and windows become screens for displaying content from our tablets or billboards for pushing content? Will the battery life of our devices negate the need for power at every workstation and in every office? Will virtual teaming technologies further redefine work as a thing rather than a place? Most of these ideas will become a reality in just a few short years. However, technology has not and will not be the only driver of major change in the workplace. Fundamental changes unrelated to technology are occurring that will continue to change the definition of work, workers and the workplace.

Shifting demographics

Quietly, a massive shift is occurring globally. The labor force is shrinking. According to Dr. Jost Lottes of Portland State University's Institute on Aging, the age pyramid is inverting and "no single trend will play a larger role in shaping the social, economic and geopolitical order throughout the developed and developing world than global aging" (Lottes, 2010, p. 2).

Historically the world has always had more young than old people. We are in the midst of a major shift to the opposite, more old than young. Accompanying this shift are the challenges of not only a diminished labor force but also the financial responsibilities of caring for an aging population as well as the potential of stagnant or declining markets.

According to Forbes, by 2020 almost half of the workforce will be Millennials (Miller, 2014) and successfully engaging them will require changes to our long held definitions of work and the workplace. Anticipating the cultural shift Millennials would bring, PwC undertook a study with the University of Southern California and the London Business School, the largest study of its kind to date (PwC's NextGen, 2014).

The key learnings from the study were that the workplace would need to create a culture of team work and community. It would have to be flexible in order to support the work life balance of not just the Millennials but also of preceding generations as both indicated a high desire for work hour and work location flexibility. Recall that our aging population means that even older generations are seeking more work / life balance as they struggle to care for aging partners while raising families.

Talent scarcity

Knowledge work requires educated and skilled people. Who these people are is rapidly changing as are their expectations of the workplace. According to the McKinsey Global Institute the global talent shortage for highly skilled college educated workers could be 38 to 40 million workers or 13% of demand. In advanced economies like North America, McKinsey predicts a gap of 11% (Dobbs, Lund, & Madgavkar, 2012). This means that in six short years business will not be able to staff nearly one of every ten critical roles. In a knowledge economy, unfilled roles equal a diminished capacity to service clients and therefore less revenue.

In the May 2013 Workplace Forecast, the Society for Human Resource Management cited the shortage of skilled workers as one of the top three concerns for 2013 and beyond. Seventy-three percent of surveyed HR professionals indicated a shortage of skilled workers will have a major impact on the US workplace over the next five years ("SHRM Workplace Forecast," 2013, p. 10).

Healthcare costs

In this same report, HR professionals indicated their number one concern for the next five years was the continuing high cost of employee health care coverage in the US. Their sentiment is echoed by the National Association of Manufacturers. In a recent survey, 82% indicated rising health care and insurance costs were their top concern (Lavoie, 2013).

Accelerating urbanization

Coupled with an aging global population, a shortage of skilled workers and changing generational expectations is a mass migration back to the city. According to the World Health Organization, as of 2010 50% of the world lived in urban areas and by 2050, seven out of every ten people are expected to live in cities ("Urban population growth," 2013). This shift back to the city impacts our fundamental view of work and workplace. Will the entire city be seen as the workplace when the long commute to Suburbia is no longer desirable? Will employees want more flexibility in when and where they work if home is only a short walk or ride from the office?

Using the workplace to manage risk

Technological advancements, aging populations, talent shortages, rising health care costs, and growing cities will reshape the definition of work and where it occurs. With such a shifting landscape, how does a business develop a workplace strategy to prepare for these changes and more specifically how can the physical workplace create a competitive advantage? How can workplace strategy help to ensure companies deliver quality and value to their customers as well as supporting company growth? Most importantly, can a business risk ignoring these trends and their impact to the workplace?

PwC has undertaken sweeping changes to its workplace to proactively prepare for these coming changes. Starting in 2007, PwC undertook an effort to continuously improve its workplace and has since implemented evolving workspace designs, technology enhancements and change management programs in cities such as Denver, San Jose, San Diego, Irvine, Atlanta, Detroit, Tampa and Los Angeles. PwC is currently planning new offices in Chicago, Boston, Florham Park, Philadelphia, Houston, and Seattle. In 2016, PwC will have refreshed nearly half of its total leased space with a new design that addresses the above trends. What follows are the lessons we've learned over the past five years.

Lessons learned

It's about the people experience

In our opinion, the goal of workplace strategy should be to

- Deliver the ideal environment;
- At the ideal time;
- That fully supports the activities of work being undertaken;
- In a cost effective manner.

In other words, we need to give our employees the right space and the right time with the right tools at the right cost. Further, what is "right" today may not be "right" tomorrow as business needs and those of our employees consistently change.

The true measure of whether the workplace is effective is the opinions of the employees. However, the physical workplace is only one component of their satisfaction. Company culture, management, etiquette, policies and numerous other dimensions can support or undermine a change to physical space. Our primary lesson learned is that a comprehensive change management program that engages all levels of the organization is essential to ensure the needs of the business, the vision of leadership and the needs of employees are aligned.

Create an appropriate mix of space

Knowledge workers require specific environments in which to work based on the activities they are undertaking. Research conducted by Gensler, a global architecture, design and consulting firm, over the past decade indicates that a mix of spaces that support various work modes is critical. Knowledge workers require spaces to focus, collaborate, socialize and learn and companies that provide a mix of environments and have a higher performing workplace also have higher profits, employee engagement and stronger market and brand position ("2008 Workplace Survey United States," 2008).

Five years later the necessity of multiple environments continues to be valid. One word best describes the expectation of tomorrow's multigenerational workforce; choice. According to Gensler's 2013 Workplace Survey, "employers who provide a spectrum of choices for when and where to work are seen as more innovative and have higher performing employees" ("2013 US Workplace Survey," 2013).

To support the need for multiple environments and choice, PwC designs a variety of spaces to support each work mode. No longer is the focus solely on individual spaces such as offices and workstations. We look at the workplace holistically and strive to ensure a balance of space types is provided from individual offices and workstations to areas for teaming, sharing and collaboration to spaces for recharging, distraction free work and socialization. One of the most popular design features in PwC space is also one of the most simple, a high top table with bar height stools. These collaborative spaces are first come, first served and are typically located in the corner of our offices where the views are best. Another popular space is PwC's work bar. Typically placed on the windows where views are best these small workspaces are ideal for quiet focused work.

Create richer experiences

Offering choices does not necessarily have to lead to taking more real estate space. In fact, PwC has been able to right size certain spaces and eliminate other spaces that were no longer needed to enable the implementation of new spaces. PwC's open workstations are now 30 square feet or less in size. The reduction in size of technology components like computers, monitors, printers and telephones and the reduction of paper work product and storage needs catalyzed this change. This reduction has enabled PwC to introduce more open collaborative areas and teaming spaces without taking additional space. Additionally, it has allowed PwC to supplement each work environment with supporting technologies. Another expectation as reported in PwC's landmark generational study, was Millennial's technology expectations. The report recommends the businesses "Fully leverage technology. Accelerate the integration of technology into the workplace, enabling workers to harness technology in ways that give them more flexibility and increase efficiency. To Millennials this is an absolute must—they expect to have access to the best tools for collaboration and execution." To meet this challenge PwC partnered with its Information Technology team to implement multi-screen media sharing, enhanced audio conferencing, video conferencing, digital signage, and a mobile application that helps staff reserve work spaces.

Spaces can be enriched with people as well as technology. PwC now designs its spaces to serve multiple purposes. Partner and Director offices are designed as team rooms that help foster the firm's cultural values of sharing and collaboration. Changing the focus of once coveted offices from individual entitlement to serving team needs has helped set the tone as the office being a shared resource that supports everyone instead of an individual resource. This "sharing" mindset greatly helps people adopt new workplace concepts and adapt to change.

Plan to change (adapt, improvise, overcome)

Given the megatrends discussed above continuous change is certain. Prior to the Dot Com Era the office did not need to rapidly change. However, now that the cycles of technological change are shorter and more dynamic, the workplace must be adaptive.

PwC is planning that the physical environment will constantly need to change to meet business requirements. As such, PwC is implementing reconfigurable wall systems, end user movable walls and furniture, and planning HVAC, electrical and network connectivity to support future configurations of the workplace. PwC is also developing lifecycles for physical space knowing that some that exist today will be obsolete tomorrow.

PwC is also exploring new technologies that can measure the actual use of office space on a minute by minute basis. This data will help inform which low use spaces can be converted to more useful spaces. We expect the rate of change to continually increase. Planning cycles will shorten and will be data driven. It's no longer adequate to hypothesize which spaces are used and which are not. Adopting ideas from the Retail industry PwC plans on measuring use of space or dwell time at the seat level to best understand how we can continually adjust space to meet changing needs. We see space as a dynamic element that can be used to increase productivity and engagement if we have the data that can inform such changes.

Rethink space as a reward

As PwC builds spaces that better support various activities or work modes and further enriches these spaces with technologies we understand that fundamentally space is no longer an entitlement or a reward but rather a tool and resource to share. PwC's proprietary hoteling system and new reservation technologies allow any employee to reserve spaces in advance via mobile devices. Sharing space or "recycling space" is a major cultural shift that requires significant change management. To support this and other workplace changes PwC has a dedicated team of change management professionals that work with each office to craft a custom change management plan.

Create well being

With heath care costs rising creating and supporting a healthy environment for employees goes far beyond air conditioning. PwC's evolving workplace design ensures that natural daylight floods the office. Cubicles walls have been eliminated so everyone can enjoy outside views. Healthy food selections are provided in the new self-serve Market being piloted in several large offices. Furnishings and construction practices are sustainable and environmentally friendly. PwC also offers work environments at different heights to allow employees the opportunity to stand and work.

Create opportunities for collisions

Do our best ideas come to us when we sit alone and force ourselves to innovate? In most cases our best ideas come to use when we are doing the exact opposite. That "ah ha" moment comes to us when we're in the shower, taking a walk, or socializing with friends. PwC has created environments to support these moments. Our Interactive Café is a place where our people can come together, refresh and socialize. PwC also wanted to create collisions between its employees as a means of sharing knowledge and innovating. In support of this goal PwC moved all food and beverage services to the Interactive Café where previously it had been located throughout the offices. Forcing people out of silos and into common space creates the opportunity to see other people, start conversations and potentially dream up the next big thing.

Summary

In conclusion, a well-designed workplace can be a strategic advantage to any business regardless of size. Most importantly it can help manage the downside risks of the trends discussed herein. Negating the value of the physical workplace and ignoring the opportunity to redesign it can result in a loss of competitive advantage and the ability to attract and retain top talent.

Steven Adams is a Director in PwC's Real Estate Services Group
He can be reached at
steve.adams@us.pwc.com

Investing in the US

The following is extracted from *Emerging Trends in Real Estate®*, *The global outlook for 2014*

The US real estate recovery is set to continue this year, with investors increasingly forsaking some of the traditionally popular cities and turning instead to secondary markets in search of higher yields.

The desire to look beyond the investment heartlands of Boston, Chicago, Los Angeles, New York City, San Francisco and Washington has been evident for some time. But 2014 may well be the year when such plans come to fruition

According to Emerging Trends in Real Estate® 2014, this search for value owes much to the fact that opportunities in core markets have become harder to find, and the best assets more expensive.

But there is a pull factor, too. The pace of the economic and real estate recovery remains uneven across US metropolitan area markets. The recovery has clearly had more momentum in cities with favorable demographics, exposure to those with growing industry sectors and those with an attractive cost of doing business.

Such trends have been in place since the recovery began but they are now evident in a much larger group of markets. The all-important consequence for the industry is an improvement in the property fundamentals of occupier demand and rental growth, which many investors regard as sustainable. As one fund manager says, "The focus is now on the top 25 markets, not the top six. We like markets that have the potential for growth."

This is not to diminish the leading investment markets of the past few years, which remain attractive and will continue to appeal to investors with certain return targets. But as a national portfolio manager says, "the outlook for a broader number of markets is that improved demand will create the kind of leasing momentum that will allow landlords to push rents."

If there is a threat to this market recovery and "leasing momentum," it is the timing and pace of any interest rate increases. The report forecasts a modest increase in the short term, but does not expect a small increase to cause a major disruption to the recovery. If higher interest rates are a function of the Federal Reserve Board's response to an improving economy in 2014, the increased borrowing cost should be offset by greater demand and therefore higher rents. Of course, faster-than-anticipated rises or rates growing faster than the underlying economy could undermine the recovery.

But as Mitch Roschelle, PwC partner and real estate advisory practice leader, puts it, the steady economic recovery and job creation so far have generated "tailwinds" that have propelled the commercial real estate market forward. "The momentum of this recovery," he says "seems powerful enough to weather spikes in interest rates that may be inevitable."

Industrial expansion

"If you are a long-term investor, the industrial sector just keeps doing well, even if it's not glamorous," says one respondent to Emerging Trends in Real Estate® 2014.

Not glamorous, perhaps, but industrial real estate in the US is nonetheless at an important juncture. The sector is starting to feel the benefit from major advances in supply chain distribution and manufacturing, whether it is on the back of e-commerce or the so-called "reshoring" of factories.

With an improving US economy also boosting the sector, it is little surprise that industrial real estate is attracting the smart money. In terms of market sector prospects, industrial tops the ranking in this year's report, with warehousing standing out as particularly strong – 64 percent of survey respondents making a "buy" recommendation for the subsector and fewer than 10 percent advising selling.

The strength of US warehousing reflects the expanding influence of e-commerce distribution networks. "Electronic retailing is impacting the whole distribution program," says one logistics executive. "Facilities are being built to enable same-day delivery – huge buildings, fulfillment centers in areas where we've never seen warehouses before."

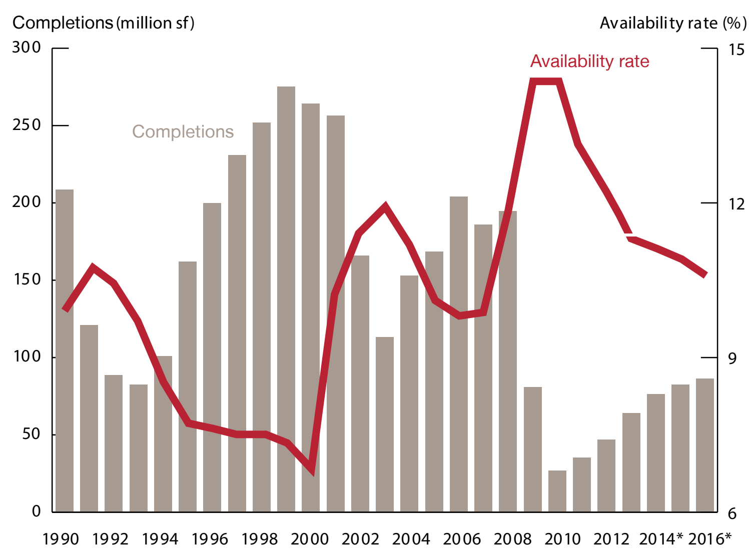
In making buy/hold/sell recommendations for the total industrial sector by metropolitan area, respondents put Miami at the top of the list, with over 60 percent of respondents rating the city as a "buy." The next top four industrial markets – Houston, Seattle, Los Angeles and Dallas – are all global distribution hubs with healthy local economies.

Industrial space in general will also benefit from the shortening of supply networks through the "reshoring" of factories to the US and the elimination of a long supply chain across the Pacific Ocean, which many companies have concluded is no longer worthwhile as employment costs in China rise. Low US energy costs are fuelling this trend as well.

New factories are also opening up in some surprising locations and in some unexpected industries. In 2013, a semiconductor manufacturer announced plans to build a facility in Saratoga County, New York, to support technology development and manufacturing activities. And it's not just American manufacturers that are looking to shorten their supply chain. Last year an Asian computer producer opened a personal computer assembly plant in Whistett, North Carolina.

Facilities are being built to enable same-day delivery – huge buildings, fulfillment centers in areas where we've never seen warehouses before.

US industrial completions and availability rates

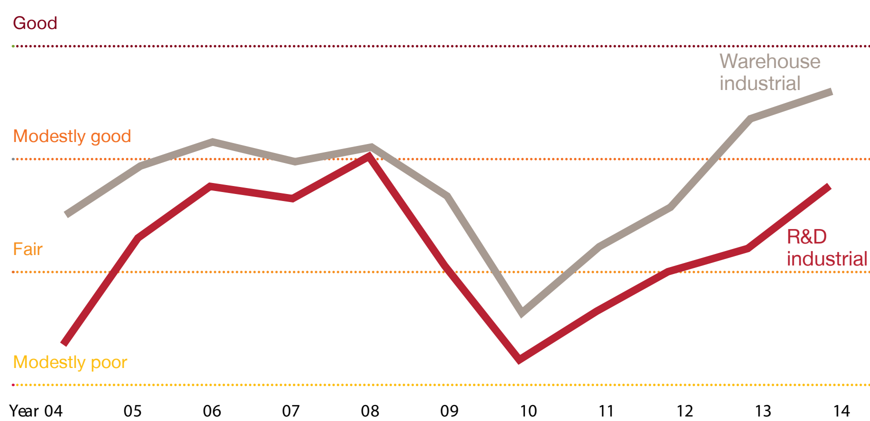


Source: CBRE Econometric Advisers
* Forecasts

"Manufacturing is coming back to the US, and it's coming back faster than we thought," says one economist. "Back in 2011, no one thought we would see anything until 2015. Now, we are seeing dozens of companies moving back to the US because the economics are shifting. A key driver of this trend is that labor costs in China are rising, with wages increasing by about 15 to 20 percent a year and the steady appreciation of the Chinese yuan against the dollar. Manufacturers are seeing very long supply chains, and there are increasing concerns about intellectual property. They were willing to accept all that before, but no longer because there's less of an advantage in labor costs."

Manufacturing is coming back to the US, and it's coming back faster than we thought.

Industrial/distribution investment prospect trends



US warehouse industrial

2014	Prospects	Rating	Ranking
Investment prospects	6.56	Good	1st
Development prospects	6.44	Modestly good	1st

Buy	Hold	Sell
63.5%	26.9%	9.6%

Expected capitalisation rate, December 2014	6.7%

US R&D industrial

2014	Prospects	Rating	Ranking
Investment prospects	5.72	Modestly good	8th
Development prospects	5.11	Fair	7th

Buy	Hold	Sell
36.0%	41.6%	22.4%

Expected capitalisation rate, December 2014	7.5%

Source: Emerging Trend in Real Estate 2014 survey
Note: Based on US respondents only

Development demand

When a recovering economy follows years of under-supply in real estate it is natural for "space market fundamentals" to emerge as the primary drivers of total returns, and so reduce the reliance on falling capitalization rates. Development also starts to figure once again in investors' plans.

The US economy expanded at an annual rate of 3.2 percent in the last three months of 2013, which was a creditable performance albeit undermined by a weak first half that dragged the annual rate of growth down to 1.9 percent for the year as a whole.

That is not huge growth, but as one fund manager suggests in Emerging Trends in Real Estate® 2014 it is "enough to create demand for real estate product – that is, demand for space and improving rent – because at the same time there's almost no new supply. It's a sweet spot for real estate."

Following on from such positive investor sentiment, the report signals that there may well be an increase in development during 2014 – and what is more, it is likely to be broadly based. Development activity has been dominated by multifamily housing in recent years – with Generation Y seeking to rent and baby-boomers looking to downsize from houses to apartments. Now it appears that other sectors are also coming into play.

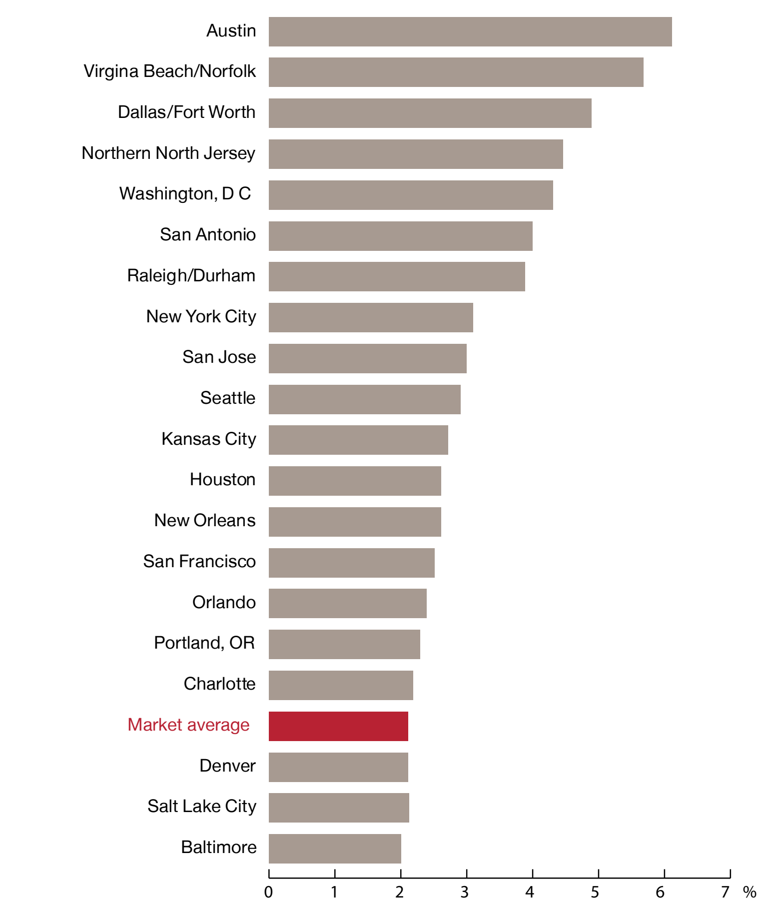
An improvement in market vacancy rates is driving higher rent growth forecasts. And the result is that development has become viable in select markets and property types and may well start feeding through to the supply figures in the coming years.

Industrial is where respondents feel the best development opportunities exist in 2014, but prospects for hotels are also expected to strengthen during the year. The office sector, too, could see an increase in redevelopment as building owners look to reposition properties to meet changing tenant demands. The improvement is also widespread in geographical terms, with 40 markets reporting an improvement in development prospects for 2014.

No-one anticipates a development boom, however. Survey respondents are comfortable that the recovery will continue even with slow growth in demand because new supply delivered remains at relatively low levels.

In 2007, real estate data providers reported that new supply of commercial real estate was ramping up but had begun fairly late in the real estate cycle. With little new construction in the post-recession years, one economist predicts: "In 2014, we could start to see some tightening as we continue to absorb space with very little new supply at all. We might see landlords push rents a little higher than you might expect."

2013 Space under construction as a percentage of inventory



Source: CBRE Econometric Advisors

The Emerging Trends in Real Estate® US, Europe and *Asia Pacific* reports are produced annually by the Urban Land Institute and PwC following interviews with the most senior property professionals. Over many years, they have become key indicators of sentiment in their respective regions.

CRE investment demand outpaces quality offerings

By Susan Smith

The following is extracted from the First Quarter 2014 issue of the PwC Real Estate Investor Survey, released on March 17, 2014. The findings and opinions reflect those of the investors surveyed and do not necessarily reflect the views of PwC.

Commercial real estate (CRE) investors are well capitalized, eager to place funds in various real estate sectors, and optimistic about the future, but the missing piece of most acquisition strategies is quality offerings. In each property sector and within many of the city-specific office markets in the Survey, a lack of quality for-sale product is noted by surveyed investors as a current challenge. “There are few decent assets on the market right now,” says one surveyed investor. “A shortage of quality deals is a problem for us,” shares another surveyed investor.

In the office sector, investors mainly see a shortage of for-sale product in metros where recoveries persist due to solid job growth and diverse local economies, like Charlotte, Denver, and San Francisco. These better-performing office markets are where many investors prefer to grow their ownership footprint. However, with too much capital chasing too few deals, buyers are becoming more aggressive in such markets. For many buyers, another large challenge is to not push pricing too much just to acquire an asset.

For the apartment sector, a diminished for-sale market is less of an issue among our surveyed investors, who appear more focused on development opportunities and watching this sector’s expanding supply pipeline. When combined with an expected slowdown in rental demand this year, the for-sale market could soon see a surge in offerings as the number of apartment markets in the contraction phase of the real estate cycle grows over the next four years. Likewise, as numerous investors look to capitalize on the ongoing recovery in the US warehouse sector, an imbalance exists in its sales arena with the number of eager buyers ahead of quality offerings.

Although some investors expect quality offerings to grow in number throughout 2014 due to upcoming debt maturities and stronger CRE fundamentals that prompt owners to sell, others speculate that owners will opt to hold stabilized assets, especially in the office sector, in order to capitalize on growing rents and avoid the task of determining where to redeploy capital in an industry thought to have a limited number of quality buying options.

Overall cap rates

According to the results of the first quarter 2014 PwC *Real Estate Investor Survey*, the average overall capitalization (cap) rate increases in six Survey markets, holds steady in nine, and decreases in 19 of them – a slight increase in the number of market declines since last quarter. The steepest decline occurs for the Dallas office market, while the Denver office market posts the largest quarterly increase.

In the Survey's national apartment market the average overall cap rate holds relatively steady while the regional apartment markets report various cap rate shifts – increasing slightly for the Pacific region, falling a bit in the Southeast region, and dropping for the Mid-Atlantic region.

Looking ahead, investors are expecting positive trends for the industry to continue in 2014, especially for the office sector, including secondary office locations, despite the expectation of rising interest rates. As a result, competition among buyers is likely to remain fierce and keep prices elevated for the best CRE properties offered for sale.

CRE sector overviews

Office

Many surveyed investors share encouraging comments for the national CBD office market as many cities register gains in both occupancy and rent growth. One challenge for some buyers of CBD office properties is deciding which urban cores will hold up in the next downturn. "We find office demand very hard to quantify right now, which can make it a bit difficult to project asset performance," comments a surveyed investor. In lieu of buying existing assets, one surveyed investor comments that "development might be the biggest opportunity in this CBD office sector."

Even though many suburban office locations experienced a decline in overall vacancy at the end of 2013, several surveyed investors see challenges with regard to this sector. One difficulty in 2014 could be winning premier tenants. Another challenge for certain owners is how to deal with functional obsolescence. Functionality issues in the office sector have increased more recently as much of corporate America rethinks its space needs and incorporates more of a high-tech vibe in its work environment.

Retail

Positive spending trends bode well for the national regional mall market, which continues to outperform the other US retail property types. When looking for regional mall buying opportunities, many investors are focused on top-performing markets along the east and west coasts of the country, steering clear of secondary cities.

As the national strip shopping center market shows broader signs of recovery accented by declining vacancy rates and increasing levels of new construction, sellers are gaining more control of price negotiations, especially given a lack of quality assets on the market. Similar to the national power center market, surveyed investors note the importance of having "the right tenant mix" at strip shopping centers.

Industrial

Key indicators for the Survey's national warehouse market reflect the optimism that many investors have for this market given its ongoing recovery and positive outlook.

The warehouse sector's improving fundamentals have piqued investor interest, creating an imbalance in the investment arena as eager buyers outnumber quality offerings. This quarter, 80.0% of our surveyed investors believe market conditions favor buyers in the national warehouse market – up from 67.0% last quarter.

Even though the vacancy rate in the US flex/R&D market declined in the last quarter of 2013, gains in occupancy and rents remain minimal. As a result, many property owners are finding it difficult to push up rental rates and reduce concessions. In fact, our surveyed investors report that free rent is still prevalent in the flex/R&D sector, a trend that will likely not subside until fundamentals markedly improve.

Apartment

In the face of the largest wave of new supply in five years, investors maintain positive expectations for future rental rate growth in the national apartment market. This quarter, our Survey results reveal a 21-basis-point increase in this market's average initial-year market rent change rate. Moreover, the low end of the range for this key indicator moves up from -2.00% to 0.00%.

While investors suggest that there are prospects for both new development and rent growth in certain markets, they remain aware of potential oversupply issues. Due to the rise in new supply and a moderate slowdown in net demand, the US multifamily market is likely to peak with regard to cycle position in 2014. The PwC real estate barometer places 89.0% of US multifamily markets in expansion through this year with a growing number of metros moving into contraction by 2017.

Susan Smith is a Director in PwC's Real Estate Practice

She can be reached at susan.m.smith@us.pwc.com

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.

The impact of the "repair" regulations on the real estate industry

By Jennifer Kennedy and Rafael Ferrales

Executive summary

On September 13, 2013, the IRS released final tangible property 'repair' regulations under Sections 162(a) and 263(a) (final regulations), regarding the deduction and capitalization of expenditures related to tangible property. The final regulations replace temporary regulations that were issued in December 2011. Also released were proposed regulations under Section 168 (2013 proposed regulations) regarding dispositions of tangible depreciable property.

In light of these regulations, taxpayers in the real estate industry will need to evaluate the impact of implementing the regulations for tax years beginning on or after January 1, 2014.

Taxpayers in the real estate industry should assess the impact of these rules, as there are both technical and practical issues that must be considered. In particular, consideration should be given to the impact of changes to the de minimis rule, the definition of a unit of property, and the rules governing the disposition of tangible assets, all of which are described in detail below. Taxpayers should also consider the availability of a new election to capitalize repair and maintenance costs. The effect of the regulations may vary based on business structure and investment strategy, as well as the taxpayer's current policies related to repair expenditures. For example, a real estate investment trust (REIT) with specific policies addressing the appropriate treatment of costs incurred to repair or maintain tangible property for financial statement purposes that has followed this approach for federal income tax purposes may consider making an election to capitalize repair and maintenance costs. If this election is not made, the REIT will need to evaluate the extent to which the repair regulations described below will give rise to a different tax result once implemented, as this will have a direct impact on taxable income available for distribution. On the other hand, a real estate fund that is audited on a fair value basis may not have a specific accounting policy to address the treatment of costs incurred to repair or maintain tangible property, and as a result, may have more practical issues to address. Specifically, consideration must be given to how repair and maintenance expenditures could be easily identified so that the federal income tax treatment of these costs can be appropriately analyzed. Another example may be a joint venture that prepares financial statements on a tax basis. In this situation, the materiality of the changes required by the repair regulations should be evaluated in light of the impact these changes will have on the financial statements.

As real estate businesses begin to evaluate the impact of the final regulations, many will likely discover that they need to change their methods of accounting associated with repair and maintenance expenditures to conform to the new rules. In light of the focus that the IRS has on this issue, it is important for real estate businesses to develop an approach for implementation of these new rules to mitigate potential questions from the IRS upon examination.

Real estate assets

The repair regulations apply to all tangible property and include a number of important changes with respect to real property. While all taxpayers must take action to comply with the new rules, the impact of the regulations on businesses in the real estate industry may differ based on business structure and investment strategy. For example, REITs typically hold properties as long-term investments. These entities may benefit from tax planning under the new rules that can affect the timing and value of their deductions.

For other businesses, whose average holding period for real estate investments is shorter, compliance with the new rules may be of greater concern than other tax planning because the acceleration of deductions may be less valuable. Businesses with shorter term investment strategies may include funds that directly invest in real estate and joint ventures. Tax-exempt investors, a significant investor group in many real estate funds and joint ventures, may not derive as much benefit from tax planning related to accelerated deductions.

What the repair regulations mean for real estate companies

The final regulations published in September 2013 create new rules related to the acquisition, production, or improvement of tangible property. These rules are meant to help taxpayers better distinguish between currently deductible repair and maintenance expenses under Section 162(a) and expenditures that must be capitalized under Section 263(a). The new repair regulations are significantly different in many respects from prior law, as well as from the 2006 and 2008 proposed versions of these regulations. Further, while the final regulations retain many provisions from temporary regulations issued in 2011 (2011 temporary regulations), these final regulations refine and simplify some of the rules and create a number of new safe harbors.

As noted above, the final regulations apply to tax years beginning on or after January 1, 2014. However, taxpayers may choose to apply the final regulations to any tax year beginning on or after January 1, 2012. Taxpayers also have the option of choosing to apply the 2011 temporary regulations to tax years beginning on or after January 1, 2012 and before January 1, 2014. The IRS expects to issue separate revenue procedures that will provide guidance pursuant to which taxpayers may obtain automatic consent to change their methods of accounting to comply with the final regulations. These revenue procedures are expected to be issued in the coming weeks.

Some of the potential impacts of the regulations important to the real estate industry are outlined below.

Costs to acquire property

Under the final regulations, taxpayers generally must capitalize the cost of acquiring real property. Amounts paid that must be capitalized include costs paid to defend or perfect title of the property, transaction costs, and costs for work performed prior to the date the unit of property (UOP) is placed in service. Activities performed by a taxpayer to determine whether to acquire real property, and which real property to acquire, are not required to be capitalized unless the cost is considered an inherently facilitative cost. Therefore, such pre-decisional investigative or pursuit costs for real property generally are not required to be capitalized.

The final regulations provide a reasonable allocation rule for taxpayers that acquire real and personal property as part of a single transaction. The allocation will allow taxpayers to deduct pre-decisional investigatory costs related to the acquisition of real property while requiring such costs related to the acquisition of personal property to be capitalized.

Amounts paid to improve or maintain property

Improvements to tangible property generally must be capitalized under the temporary regulations. A UOP has been improved after it has been placed in service if the activity performed on the property results in a betterment to the UOP, restores the UOP, or adapts the UOP to a new or different use.

Although a building and its structural components generally are treated as a single UOP, the regulations require that the improvement standards be applied separately to the primary components of a building (whether owned or leased), meaning the building structure (e.g., floors or walls) or any of the specifically defined building systems. The building systems are broken out into nine components: heating, ventilation, and air conditioning (HVAC) systems; plumbing systems; electrical systems; escalators; elevators; fire protection and alarm systems; security systems; gas distribution systems; and other structural components as defined in published guidance. Accordingly, a cost is treated as a capital expenditure if it results in an improvement to the building structure or to any of the specifically enumerated building systems.

While the regulations clarified the UOP rules related to buildings and their structural components by specifically enumerating applicable building systems, they did not clarify the improvement standards by creating an exception, safe harbor, or bright-line test associated with minor and recurring refresh or remodel costs. Instead, the analysis of whether refresh or remodel costs result in an improvement continues to be focused on the specific facts and circumstances. Accordingly, the final regulations merely provide detailed examples that result in a wide range of outcomes, based on the nature and extent of the work performed on the building and its structural components. While some of these examples are helpful and provide insight into the rationale for the conclusions reached, others seem to draw conclusions without providing much explanation.

Due to the subjective nature of the improvement standards, taxpayers may continue to experience uncertainty in the application of the law to situations involving refresh or remodel costs, and potential controversy upon audit. This may require taxpayers to spend more time documenting their related tax return positions, as well as their financial statement reserves for uncertain tax positions.

Routine maintenance safe harbor for buildings

The final regulations include a safe harbor for routine maintenance expenditures. This safe harbor provides that amounts paid for routine maintenance on a UOP are not required to be capitalized as an improvement to that property. Routine maintenance for a building is defined as recurring activities to a building UOP that a taxpayer expects to perform as a result of the taxpayer's use of the building UOP in order to keep the building system in its ordinarily efficient operating condition. Such activities are considered routine only if, at the time the UOP is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during a 10-year period beginning when the building structure or building system upon which the routine maintenance is performed is placed in service by the taxpayers.

The routine maintenance safe harbor for buildings may be useful in a fairly limited number of circumstances.

The examples in the regulations are related to scheduled maintenance on elevators or HVAC systems, expenditures that many taxpayers already expense.

De minimis capitalization rule

The final regulations incorporate substantive changes to the de minimum capitalization rule (de minimis rule) provided in the 2011 temporary regulations. The final regulations provide that a taxpayer may elect to expense the cost of acquired property that does not exceed a certain dollar amount. The de minimis rule is applied at the invoice or item level, based on the policies that the taxpayer uses for its financial accounting books and records. The invoice or item dollar limit relies upon whether a taxpayer produces an applicable financial statement (AFS).

Taxpayers with an AFS are allowed a $5,000 per invoice or item limit. Taxpayers without an AFS may apply the de minimis rule if the amount paid for property does not exceed $500 per invoice or item. The de minimis rule is a safe harbor that may be elected annually and must be applied to all amounts paid in the tax year for tangible property that meet the requirements of the de minimis rule. Taxpayers may not revoke an election to use the de minimis rule.

Based on this new rule, taxpayers will need to consider how assets capitalized for federal income tax return purposes will be tracked to the extent they are not capitalized for financial statement purposes. This could mean a change to internal processes, controls, and related systems.

Election to capitalize repair and maintenance costs

The final repair regulations also include an annual election to treat amounts paid during the tax year for repair and maintenance to tangible property as amounts paid to improve that property. If a taxpayer incurs costs in a trade or business and if the taxpayer treats these amounts as capital expenditures on its books and records used in computing income, these costs may be capitalized and depreciated for tax purposes. A taxpayer making this election for a tax year must apply this method to all amounts paid for repair and maintenance of tangible property treated as capital expenditures on its books and records during that tax year.

This election is a welcome simplification for taxpayers that overcapitalize repair costs and were concerned about the burden of compliance with the new regulations. However, the election to capitalize repair and maintenance costs does not release the taxpayer from the obligation to capitalize for tax purposes amounts required to be capitalized under the final repair regulations that have been expensed on the taxpayer's books and records. As a result, taxpayers still will need to analyze the final repair regulations vis-à-vis their book capitalization methods to ensure compliance with the final repair regulations.

Dispositions of real property

A disposition of an asset includes the sale, exchange, retirement, physical abandonment, destruction, and transfer to a supplies, scrap, or similar account. The 2013 proposed regulations would provide that a building, including its structural components, is the asset for disposition purposes. Further, the definition of a disposition for MACRS property would include the retirement of a structural component (or a portion thereof) of a building only if the partial disposition rule (discussed below) applies to such structural component (or portion thereof). This change would allow taxpayers to forgo a loss upon disposition of a structural component of a building without making a general asset account (GAA) election, and therefore would eliminate the potential administrative burden related to tracking the components in separate or specific GAAs.

Under the 2013 proposed regulations, the disposition rules would apply to a partial disposition of an asset. This would allow taxpayers to claim a loss upon the disposition of a structural component (or a portion thereof) of a building or a component (or a portion thereof) of any other asset without identifying the component as an asset before the disposition event. Further, the rule would minimize instances in which an original part and any subsequent replacement(s) of the same part would be required to be capitalized and depreciated simultaneously.

The partial disposition rule generally would be elective except in the following cases in which application of the rule is mandatory:

- The disposition of a portion of an asset resulting from a casualty event described in Section 165,
- The disposition of a portion of an asset for which gain – determined without regard to Section 1245 or 1250 – is not recognized in whole or in part under Sections 1031 or 1033,
- The transfer of a portion of an asset in a step-in-the-shoes transaction described in Section 168(i)(7)(B), or
- The sale of a portion of an asset.

A taxpayer could elect to apply the partial disposition rule on an asset-by-asset basis on the timely filed original federal tax return, including extensions, for the tax year in which the portion of the asset is disposed. If a taxpayer disposes of a portion of an asset and the partial disposition rule applies to that disposition, the taxpayer would have to account for the disposed portion in a single-asset account beginning in the tax year in which the disposition occurs.

Importantly, while the 2011 temporary regulations made a variety of changes to the existing rules under Section 168(i)(4) regarding dispositions of assets from general asset accounts, the proposed regulations revert to the prior, more restrictive definition that existed prior to the modifications made by the 2011 temporary regulations.

Why does your business need to address the repairs regulations now?

Effective January 1, 2014

The final regulations are effective for tax years beginning or on after January 1, 2014.While the proposed regulations regarding dispositions are not finalized, the IRS stated in the preamble to those regulations it plans to finalize the regulations in 2013 with application to tax years beginning on or after January 1, 2014. If the 2013 proposed regulations are not finalized until 2014, taxpayers should be aware of the possibility that the final regulations for dispositions could be applied retroactively to tax years beginning on or after January 1, 2014.

Accounting method changes

As noted above, many real estate industry taxpayers will need to change their methods of accounting associated with the repair and maintenance of tangible property to conform to the new rules. The IRS expects to publish guidance on accounting method changes to comply with the final and proposed regulations in the coming weeks, and it is likely that taxpayers will be expected to file any required accounting method changes prior to the due date of the tax return for the first tax year beginning on or after January 1, 2014.

IRS examinations

The IRS' Large Business & International Division issued a directive to field examiners in connection with examinations of the repair versus capitalization issue. For tax years beginning before January 1, 2012, the directive instructs field examiners to discontinue current examination activity with regard to the issues covered by the directive, and not begin any new exam activity with regard to those issues. However, the directive adds that if a taxpayer files a Form 3115 with regard to those issues on or after December 27, 2011, for a tax year not covered by the repair regulations, then field examiners should perform a risk assessment regarding the issues.

For tax years beginning on or after January 1, 2012, but before January 1, 2014, the directive instructs field examiners to determine whether the taxpayer has filed a Form 3115 in accordance with the applicable guidance. If the taxpayer has filed a Form 3115, then the examiner should perform a risk assessment regarding the method change. If the taxpayer has not filed a Form 3115, and the taxpayer is still in its first or second tax year beginning after December 31, 2011, then the examiner should not examine the issues and allow the taxpayer until the end of that period to file a Form 3115. If the taxpayer has not filed a

Form 3115 by the end of that period, then the examiner should perform a risk assessment regarding the issues. For tax years beginning on or after January 1, 2014, the directive notes that field examiners should follow normal examination procedures. It is unclear whether the directive will be modified in light of the issuance of the final regulations.

Action items and benefits for real estate taxpayers

There are a number of items that real estate companies should consider in analyzing the impact of the new regulations on their businesses. Some of these items are outlined below.

Review current capitalization policies and prior year repairs studies

Complying with the new repair regulations likely will require many taxpayers to change their methods of accounting.

Except in limited circumstances, the regulations require a full Section 481(a) adjustment, which means taxpayers are going to need to review their current capitalization policies and any prior year repairs studies in order to conform to the new rules. Based on the new rules, some taxpayers may find that they have over-capitalized their repair expenditures, while others (especially those that previously undertook a repairs study) may find that they have over-deducted them. In either case, taxpayers should consider filing a Form 3115. By doing so, taxpayers that have over-capitalized their repair expenditures will receive an additional benefit through a one-year cumulative catch-up adjustment.

On the other hand, those that have over-deducted their repair expenditures will receive audit protection, but at the cost of recapturing the excess deductions over a four-year period. Taxpayers that have over-deducted their repair expenditures, and are required to recapture disallowed deductions over a four-year period, should be especially vigilant about understanding the impact this might have on cash flow assumptions and estimated tax payment obligations, as well as financial statement reserves for uncertain tax positions. The impact on tax returns also should be considered.

Evaluate the need for systems enhancements

The rules contained in the final regulations will require many taxpayers to evaluate the adequacy of certain systems and software programs. For example, the UOP and de minimis rules will require taxpayers to consider how assets that may have to be capitalized for federal income tax return purposes will be tracked to the extent they are not capitalized for financial statement purposes.

Cost segregation of real property

The disposition rules requiring the recognition of gain or loss in connection with partial dispositions of structural components necessitate that taxpayers track the costs of the enumerated building systems. Real estate companies should consider having future cost segregation studies analyze the costs of these building systems to take advantage of future dispositions.

Jennifer Kennedy is a Partner in PwC's Real Estate Tax practice
She can be reached at
jennifer.kennedy@us.pwc.com

Rafael Ferrales is a Director in PwC's Real Estate Tax practice
He can be reached at
rafael.j.ferrales@us.pwc.com

Update on BEPS and recent changes in tax rules

By Oscar Teunissen, Sulay Sinha, and Heidrun Ziche

The year 2013 has seen its share of legislation and proposals in the tax and withholding rules that impact real estate investment across the globe. The summary below highlights some of the major changes that have occurred or been proposed this year that may impact investments in or are structured through these nations.

Importantly, the Organization for Economic Cooperation and Development (OECD) published an action plan regarding base erosion and profit sharing (BEPS) which affects asset managers globally.

Mexico has approved a 2014 tax reform package, Ireland introduced regulations regarding the setting up of Irish Real Estate Investment Trusts (REITs), and Spain made a significant number of amendments to their domestic REIT regime. France has made an approach to Luxembourg regarding the renegotiation of the existing double tax treaty. Further, France enacted a 2014 budget focusing on anti-abuse and revenue raising measures. Mauritius significantly changed its corporate substance requirements and India increased withholding reporting and disclosure requirements for transactions involving Cyprus. Australia released a federal budget that could affect US multinationals investing in Australia.

The German Conciliation Committee reached an agreement to end Real Estate Transfer Tax blocker schemes.

1. BEPS

OECD Action Plan on BEPS and its impact on asset managers

In February 2013, the Organization for Economic Cooperation and Development (OECD) published a report on base erosion and profit shifting (BEPS). The BEPS report is based on the growing perception that governments lose substantial corporate tax revenues because of companies moving profits to lower tax jurisdictions and expenses to higher ones. The report was followed in July by an Action Plan paper that addressed these perceived flaws in the international tax system. The Action Plan calls for a detailed investigation into the business activities of multinationals and specifies 15 separate action items over the next 18-24 months.

The 15 action items proposed in the Action Plan can be grouped into four general categories: (i) general actions directed at addressing BEPS such as neutralization of the effects of hybrid mismatch arrangements, limit base erosion via interest deductions and other financial payments, and counter harmful tax practices; (ii) transparency and disclosure actions which would require taxpayers to disclose aggressive tax planning arrangements; (iii) treaty related actions that revolve around the prevention of treaty abuse; and (iv) permanent establishment (PE) and transfer pricing actions focusing on changes to the definition of PE and assurance that transfer pricing outcomes are in line with value creation with regard to intangibles, risk and capital. While the BEPS agenda is not specifically targeted at asset management groups, there will be collateral impact arising from changes in the approach of tax authorities and changes in the legislation. These changes could have a broad impact, and we have summarized below some of the key areas that are relevant to the asset management business. Note that BEPS is broadly consistent with the attitude of many taxing authorities and may serve to give them more confidence to act. We are already witnessing countries (e.g., Netherlands and Mexico) taking action, perhaps with a goal of unilaterally becoming "BEPS compliant."

Prevent Treaty Abuse

Treaty abuse has been identified by the OECD as one of the most important sources of BEPS concerns. This action item identifies a series of measures to ensure that taxpayers cannot inappropriately use bilateral treaties to generate double non-taxation for an activity. The action, which is due in September 2014, will attempt to develop best practice anti-abuse clauses for use within treaties and best practice anti-avoidance rules that jurisdictions can implement within their domestic tax system.

Observation: Asset managers and the hedge funds and private equity funds under their management that invest globally through entities located in countries with a favorable treaty network can expect an increase in scrutiny of eligibility of treaty benefits. Tax authorities in many countries have already become more aggressive in recent years challenging the treaty residence status focusing on tax residence, beneficial ownership, and substance. With this action item, we expect future treaties to increasingly include anti-abuse and anti-treaty shopping clauses, such as US style LOB provisions. Some jurisdictions have already begun proceeding in this direction (e.g., Japan/UK and Japan/Netherlands treaties).

Artificial Avoidance of PE status

Under this action item, changes to the definition of PE are proposed to prevent the artificial avoidance of PE status. The plan identifies two areas of concern. First, the use of "commissionaire arrangements" where there may be a shift of profit from one country to another in circumstances where there is no substantive change in the functions performed in the first country. Second, the artificial fragmentation of global operations among group entities to qualify for the "preparatory and auxiliary" exception to PE status. The OECD will work on amending the dependent agent test and the specific provisions dealing with preparatory and auxiliary services in the Model Treaty. Changes are expected by September 2015.

Observation: Many asset managers have a global presence, either through advisory companies in other countries or where their employees are travelling to other regions to source deals, work with joint-venture partners and service providers, develop relations with investors and do research and analysis. As it is expected that the definition of what constitutes a PE will change, it is important to review such activities and their potential to create a PE and subject the funds or management company to tax in a country outside its country of formation. Additionally, the widening of the dependent agent PE tests may lead to additional risks of PE challenge in jurisdictions without trading safe harbors for offshore funds.

Assure that transfer pricing (TP) outcomes are in line with value creation

The key principle in this area is to ensure that the attribution of value for tax purposes is consistent with the economic activity generating that value. Changes to the TP guidelines and possibly to the Model Treaty (to be completed within two years) will focus on ensuring that inappropriate returns do not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules will require an alignment of returns with value creation and the activities of people. The rules imply a clear “substance” agenda.

Observation: Asset managers are likely to see that intercompany service fees, sub-advisory fee arrangements, marketing fees and other allocation of expenses come under more scrutiny. Funds investing in intangible assets such as brand names licenses etc., should review strategies allocating profits to an entity that is based in a low tax jurisdiction merely as a result of legal ownership of the intangibles. The OECD has indicated that updated TP guidelines will require alignment of returns with value creation, and asset managers should assess the need for conducting analysis (e.g., review and documentation of the functions performed) to support profit splits with their foreign advisory entities Cost plus, a method perhaps employed historically, is under more pressure in the current environment.

Neutralize the effects of the hybrid mismatch arrangements

The action on hybrids is premised on the need to address gaps created by the interactions between domestic tax laws through the use of such hybrid entities and hybrid instruments to achieve unintended double non-taxation or long-term deferral (e.g., by double deductions, or generating deductions without corresponding income inclusions). The OECD plans to develop model treaty provisions and provide recommendations regarding the design of domestic hybrid rules by September 2014.

Observation: Funds may use entities in their investment structures that can be treated as partnerships in one country and as a corporation in another. In addition, funding instruments can in many cases be treated as debt in one country and as equity in another. The focus on the use of hybrid instruments and hybrid entities, in coordination with the work on interest expense deduction limitation, will likely reduce the benefits of such strategies and limit the ability of such instruments to access treaty withholding tax reductions.

Counter harmful tax practices

This action item is aimed at the actions of governments, not companies. The BEPS report calls for solutions to counter harmful tax regimes more effectively, taking into account factors such as transparency (including exchange of information) and on requiring substantial activity for any preferential tax regime. A holistic approach is required to evaluate harmful tax practices in the BEPS context. This action item aims to initially review the member country tax regimes, and then expand participation of this action item to non-OECD member states, before finally develop revised criteria of harmful tax practices by September 2015.

Observation: Investment funds with entities in “no or low effective tax” jurisdictions or with entities that benefit from favorable tax rulings should monitor these developments. This work stream can result in an increase on exchange of information (including rulings) between countries and will likely put pressure on tax regimes providing incentives without significant substance and presence in such regimes.

Limit Base Erosion via interest deductions and other payments

The focus here is on BEPS achieved by excessive deductible payments such as interest and other financial payments. The scenarios of concern are where there are excessive interest deductions for the borrower in one country with no corresponding taxation for the lender in the other country, and where debt is used to finance tax exempt or deferred income. Best practice recommendations will be developed by September 2015 for domestic law limitations on related and unrelated interest expense and economically equivalent payments.

Observation: This action item should be monitored by asset managers using blocker entities that are financed with debt and private equity funds financing acquisitions of portfolio companies with debt. Many countries already have domestic interest deduction limitations in place, but the best practice recommendations coming out of BEPS may change some of these domestic rules and further reduce the benefit of deductions.

The takeaway

The BEPS agenda is expected to bring significant changes to the current international tax framework in the next two years or so, and can have substantial impact on asset management groups. Many action items of the BEPS Action Plan are consistent with the current attitude of fiscal authorities. For example, securing tax rulings can be expected to become more difficult and tax authorities expected to be more discerning and more focused on issues such as substance and business purpose as part of the ruling process. Asset managers should monitor the progress of the BEPS Action Plan carefully and identify the risk areas that are material to their group.

2. Mexico

Mexican Congress Approves the 2014 Tax Reform

Mexican Congress approved the 2014 Mexican tax reform package which entered into force per January 1, 2014. The tax reform package includes a variety of changes. Some of the key tax reform provisions are highlighted below.

Income tax

The current income tax law is repealed. The following summarizes the most salient aspects of the new income tax law. The new law maintains the current 30% corporate income tax rate, i.e., the previously scheduled reduction to 29% in 2014 and to 28% in 2015 has been eliminated. Also, certain deductions are not allowed under the new law.

Further, the special tax treatment that has previously been applicable to Real Estate Investment Companies (REICs or SIBRAS) has been eliminated under the new law.

Foreign residents

With regard to foreign residents, the new law increases the top tax bracket rate for individuals from 30% to 35%. This is also the top withholding tax rate that will apply to most Mexican-sourced payments made to non-residents. Note, however, that tax treaties may allow for reduced withholding rates if the taxpayer meets certain requirements.

According to the new law 10% income tax applies on capital gains realized on the sale of shares (including certificates of participation in trusts, ownership interest, etc.) listed on the Mexican stock exchange. Such shares currently are exempt from tax. Tax treaty relief will be available where the relevant conditions are met.

The new law also introduces a new 10% income tax withholding on dividends distributed to resident individuals or foreign residents (including foreign corporations). This new withholding tax will apply beginning in 2014, but not to distributions of profits subject to corporate-level tax prior to 2014. This provides an opportunity to apply reduced withholding rates under an applicable tax treaty.

Other

Some of the rules for financial service entities remain the same, e.g., the interest regime or the 4.9% income tax withholding rate applicable to interest paid to banks that are resident in countries with which Mexico has signed a tax treaty has not been changed.

However, the new law has also introduced a number of other changes, e.g., effective January 1, 2015, the new law eliminates the 100% tax deduction for a mining company's pre-operating expenses.

The existing tax consolidation regime is repealed and new rules apply for computing deferred tax.

The VAT rate applicable in the border area has been increased from 11% to 16%.

The flat tax and the tax on cash deposits have been repealed.

3. Ireland

Irish Real Estate Investment Trust (REIT)

Ireland has recently, via the Finance Act 2013, introduced regulations governing setting up of Irish REIT's. REITs are new to Ireland. Investing in REITs allows the investors to get broadly the same after-tax return from REIT investments as if a direct investment was made (i.e., taxes are paid only at the individual shareholder level). A REIT is generally not subject to tax in respect of income of its property rental business or chargeable gains accruing on the disposal of assets of that property rental business. Further, by investing in Irish REITs, non-resident investors will be able to avail of Ireland's extensive tax treaty network in order to reduce / eliminate tax withheld on dividend payments.

A company does not become a REIT until it has given notice to the Irish Revenue and complies with a series of conditions. E.g., from day 1, the REIT must be resident in Ireland and not resident elsewhere, and it must be a company incorporated in Ireland under the Companies Act. Further, the REIT must not be a closed company and its shares must be listed on the main market of a recognized stock exchange in an EU Member State. A number of additional conditions apply regarding the REITs business, assets, income, and property financing. Also, certain distribution requirements need to be fulfilled per each accounting period.

4. Spain

Spanish Real Estate Investment Trust (REIT)

On December 28, 2012, the Spanish Official Gazette published a number of significant amendments to the domestic REIT regime (SOCIMI). The SOCIMI dates back to 2009. The economic turmoil, the severe real estate market crisis, and the stringent requirements are to be blamed for the poor record of entrants to the SOCIMI regime so far. The SOCIMI reform seeks to turn the SOCIMI into a more standard and attractive REIT vehicle mainly through the reduction of the corporate income tax from 19% to 0% in the REIT vehicle as well as the relaxation of many of the existing requirements. The new SOCIMI applies for tax periods beginning January 1, 2013.

A number of measures have been introduced in order to make some of the requirements more flexible and the regime more attractive overall. E.g., some asset test conditions have been abolished; listing is extended; and the minimum share capital is reduced from EUR 15 million to EUR 5 million. Also, distribution requirements for income other than dividends and capital gains sourced from real estate is reduced from 90% to 80%. The SOCIMI is now generally required to pay a 19% "special tax" on dividends distributed to shareholders holding an interest of at least 5% that are either tax exempt or subject to a tax rate below 10%. Dividends are subject to withholding taxes according to domestic rules and applicable tax treaties.

Taxation is now focused on the investors rather than on the REIT vehicle. Under the old rules, the effective taxation on income in Spain for non-residents was 19% as they were generally not subject to any withholding at source. Under the new rules, the final tax leakage on dividends may be lower taking into account the combined application of certain tax treaties and domestic taxation in the jurisdiction of the investor. Special attention needs to be paid to the taxation at the investor level in order to avoid the 19% special tax.

5. France

France – Luxembourg Double Tax Treaty

It has been reported that France has made an approach to Luxembourg regarding the renegotiation of the existing double tax treaty which is in place between the two countries. At this stage, we have little information on the commencement of such a process, and there has been no information forthcoming from the Luxembourg or French tax authorities on the scope of any changes or, indeed, the timetable for any renegotiation process. The key point of discussion is thought to concern the taxation of capital gains arising on the direct and indirect disposal of French real estate.

Under the France- Luxembourg double tax treaty, as currently drafted, shares in a company holding real estate are not considered to be "immovable property." The treaty provides that gains arising on such a disposal are to be taxable only in the territory in which the entity making the disposal is tax resident. Hence, on a disposal by a Luxembourg tax-resident entity of shares in a second entity (itself tax-resident either in France or in Luxembourg) which holds real estate located in France, any gain arising is taxable only in Luxembourg. The relevant provisions of Luxembourg tax law are then in point, including the potential application of the participation exemption regime.

The possibility of the introduction of a "prépondérance immobilière" clause into the France- Luxembourg double tax treaty cannot be ruled out, as this is already a feature of most double tax treaties negotiated by France. Were such a clause to be added to the treaty, then shares in an entity holding predominantly real estate assets could also be considered to be "immovable property" for the purposes of the treaty.

In such a case, any capital gains arising on a disposal of shares in a company holding real estate could, in future, be taxable only in the territory in which the real estate is located. Using the example above, this could result in gains arising on the disposal of shares in an entity (resident in Luxembourg or France) holding real estate in France being taxable only in France, rather than in Luxembourg, as is the case now. Given that a full participation exemption may currently be available in Luxembourg in respect of gains arising on such a disposal, this is potentially a very significant amendment.

France Enacts 2014 Budget Focusing on Anti-Abuse and Revenue-Raising Measures

France enacted the Finance Act for 2014 and the Amended Finance Act for 2013 on December 30, 2013. Most enacted measures apply immediately and in some cases retroactively.

The two acts contain revenue-raising and anti-abuse provisions that will affect entities operating in France. However, some major provisions, such as the measure targeting intra-group transfers of risks and functions, which has been included in the Finance Act for 2014 as adopted by the parliament, have been struck down by the Constitutional Court, and therefore will not take effect.

New Anti-Hybrid-Financing Measure Enacted

The Finance Act for 2014 adds a new test to the existing rules governing interest deductions for financing by a party that is directly or indirectly related to a French borrower. Under the new rule, interest deductions will be allowed only if the French borrower demonstrates that the lender is, for the current financial year, subject to a corporate tax on the interest income that equals 25% or more of the corporate tax that would be due under French tax rules. When the lender is domiciled or established outside of France, the corporate tax determined under French law equals the tax liability that the lender would have owed on the interest had it been resident or domiciled in France.

Taxpayers must provide documentation to support the corporate tax calculation if requested by the French tax authorities. It is still unclear whether the interest disallowed under this provision will be considered a deemed distribution and therefore subject to French withholding tax and 3% distribution tax.

When the lender is a flow-through entity or a qualifying collective investment vehicle constituted under French law, under the law of an EU member State, or under the law of a country that has concluded a mutual administrative assistance agreement with France and that is not blacklisted by France, the test will be assessed at the level of the holder of shares or units. This measure applies retroactively to interest booked during tax years ending on or after September 25, 2013.

French listed REITs (SIICs)

The amended Finance Act for 2013 confirms that French listed REITs (SIICs) remain exempt from the 3% distribution tax on dividend distributions on or after January 1, 2014. However, their dividend distribution obligations have increased from 85% to 95% of profits deriving from rental activity and from 50% to 60% of profits deriving from real estate capital gains for fiscal years closing on or after December 31, 2013.

VAT Reminder

Under the Finance Act for 2013, enacted on December 31, 2012, the standard VAT rate has increased from 19.6% to 20% and the intermediate VAT rate has increased from 7% to 10% beginning January 1, 2014. The reduced VAT rate of 5.5% and the special VAT rate of 2.1% remain unchanged.

Other tax matters

The Finance Act for 2014 increases the temporary surtax rate to 10.7% from the current 5%, leading to a maximum effective tax rate of 38%.

Further, entities operating in France will be subject to a temporary tax on remunerations in excess of EUR 1M granted to an employee in 2013 and 2014. The tax rate is 50%, but tax cannot exceed 5% of the gross revenue realized by the enterprise for the year during which the tax is due.

The acts also include a number of other tax provisions affecting, e.g., wealth tax, individual taxation, and procedural requirements.

6. Mauritius

Mauritius Significantly Changes its Corporate Substance Requirements

Effective January 1, 2015, the Mauritian Financial Services Commission (the Commission) will require Category 1 Global Business Companies (GBC 1s) to have a local presence that could be reasonably expected from a corporation 'managed and controlled' in Mauritius. A GBC 1 is a resident company for taxation purposes. As such, a GBC 1 generally benefits from Mauritius' extensive double tax treaty network as well as its lower domestic corporate and withholding tax rates.

Under current law, Mauritius recognizes a GBC 1 entity if it satisfies limited substance requirements, such as having at least two directors resident in Mauritius, maintaining a principal bank account in Mauritius, and preparing audited financial statements in Mauritius.

Under the new rules, corporations will have to meet at least one additional requirement, such as having office premises in Mauritius, holding assets in Mauritius, making a certain amount of local expenditures annually, or employing local staff.

7. India

India Increases Withholding Reporting and Disclosure Requirements for Transactions Involving Cyprus

As an anti-avoidance measure, the Indian government amended its domestic tax law in 2011 with respect to transactions with taxpayers located in certain tax jurisdictions. The Indian revenue authorities issued a press release on November 1, 2013 indicating that Cyprus will be regarded as a 'notified jurisdiction' and, thus covered by these regulations.

The regulations prescribe among others the application of 30% (or higher) withholding tax for payments from India to Cyprus. The regulations also provide that an Indian entity will be subject to tax on any funds received from Cyprus unless the Indian taxpayer can explain the Cypriot person's source of those funds (including beneficial ownership). Further, transactions by Indian taxpayers with any person located in Cyprus will be deemed to be transactions between related parties. In addition, certain deductions will be subject to restrictions.

On December 3, 2013, the Cyprus Ministry of Finance issued a press release indicating that consultations were held between the Government of India and Cyprus in November 2013 and both delegations agreed that, the circumstances that had caused India to notify Cyprus as a "notified jurisdictional area" under section 94A of the Act on November 1, 2013, can be immediately addressed by:

- Agreeing to adopt the provisions of the new Article 26 of the OECD Model Tax Convention (approved by the OECD Council on July 17, 2012) relating to Exchange of Information in a new tax treaty between the two countries; and
- Improving the channels of communication and exerting every effort in facilitating each other in processing requests and responses in a swift and effective manner.

The press release also states that, once the notification of Cyprus being notified as a "notified jurisdictional area" under section 94A of the Act would be rescinded, it would be done with retrospective effect from November 1, 2013 (i.e. date of issue of the original notification). Further, the press release also indicates that the revised tax treaty (post renegotiation) between the two countries is expected to be finalized soon.

8. Australia

Australia's federal budget measures could affect US multinationals investing in Australia

The Australian 2013-2014 federal budget, released on May 14, 2013, contains a number of measures aimed at increasing Australian tax revenue. Several of the proposals may be relevant for inbound and outbound investors in Australia. Most notably, the budget proposes to amend the Australian thin capitalization rules by reducing the safe harbor debt amount from 75% to 60% of adjusted Australian assets (an effective debt/equity ratio of 1.5:1 compared to the current 3:1 ratio).

The budget also contains proposals to limit the deductibility of Australian debt raised for foreign investments and to remove the existing participation exemption for dividends received from foreign companies on shares that, for Australian tax purposes, qualify as debt interests under the Australian debt/equity rules.

Most of the proposed measures, including the thin cap legislation, are set to apply for tax years commencing on or after July 1, 2014. This would defer the proposals' application for companies with a calendar year end to the year beginning January 1, 2015.

9. Germany

German Conciliation Committee reaches agreement to end Real Estate Transfer Tax (RETT) Blocker Schemes and amends the RETT Group Clause

Under current German law, RETT is triggered if a purchaser amalgamates at least 95% of the shares in a property holding company.

From June 7, 2013, the previous RETT Blocker Scheme, under which no RETT was triggered if the purchaser indirectly acquired more than 95% of the shares, provided a third party holds a minority share, is not available any more.

According to the new rules, for calculating the 95% threshold, any direct and any indirect holdings in a property company will be considered. The new rule apply on all transactions from June 7, 2013 on as that is the date the bill was passed by the German Federal Parliament.

10. Parent Subsidiary Directive

European Commission Proposes Amendments to Parent Subsidiary Directive to Tackle Hybrid Loans and Introduce Common General Anti-Abuse Rule

On November 25, 2013, the European Commission (EC) proposed amendments to the Parent Subsidiary Directive (PSD) in the context of the fight against tax fraud and evasion and aggressive tax planning / base erosion and profit sharing (BEPS) in the European Union (EU). The proposal seeks to tackle hybrid financial mismatches within the scope of application of the PSD and to introduce a GAAR to protect the functioning of the directive.

The proposal follows the political guidance agreed in 2009 within the EU's Code of Conduct Group on business taxation to avoid the distorting effects of mismatches resulting from differences in the tax treatment of hybrid loans (PPLs) between EU Member States. The proposal allows this political guidance to be implemented in domestic tax law. If the EC's proposal would be adopted by the EU Member States, Art. 4(1)(a) of the PSD would provide that where a parent company, by virtue of its association with its subsidiary, receives distributed profits, the Member State of the parent company shall refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary of the parent company.

The EC also proposes to replace the current anti-abuse provision in the PSD by inserting a common GAAR, based on the similar clause included in its December 6, 2012 ATP Recommendation.

Oscar Teunissen is a Partner and the Global Leader of PwC's International Tax Services group in the Financial Services practice
He can be reached at
oscar.teunissen@us.pwc.com

Sulay Sinha is a Director in PwC's International Tax Services Financial Services Real Estate Group
He can be reached at
sulay.sinha@us.pwc.com

Heidrun Ziche is a Manager in PwC's International Tax Services Financial Services Real Estate Group
She can be reached at
heidrun.e.ziche@us.pwc.com

Identifying state and local real estate transfer taxes issues: A basic overview

By Sean Kanousis and Adam F. Robbins

Background

Prior to 1968, the federal government imposed a documentary stamp tax on documents that transferred an interest in real property between two different persons or legal entities. After the federal government repealed its documentary stamp tax in 1967, states stepped in and began imposing their own deed recordation taxes on the transfer of real property, or an interest therein. Historically, these deed recordation taxes were imposed on the recordation on the deed or other legal document underlying the real property transfer, with the tax base being either the consideration paid or in some instances the fair market value of the property. In addition to state level transfer taxes, may local jurisdictions have imposed their own deed recordation taxes, often piggybacking on their respective state level transfer taxes but in some cases these local taxes can be wholly independent from any state level tax.

In recent years, some state and local jurisdictions have also begun imposing a transfer tax on the transfer of ownership interests in legal entities that directly or indirectly own real property located in their jurisdictions. These taxes are often referred to as controlling interest transfer taxes, though the transfer of less than a controlling interest can trigger the tax in some jurisdictions such as Delaware and New Hampshire. These controlling interest transfer taxes focus on the transfer of ownership interests in property owning entities rather than the transfer of the underlying real property. Unlike deed recordation taxes whose application is relatively uniform across most jurisdictions, controlling interest transfer taxes are more complex with varying rules from one jurisdiction to the next regarding the applicability of these taxes. It is important to note that the combined state and local transfer tax rates can vary greatly depending on the jurisdiction where the real property is located when dealing with either deed recordation taxes or controlling interest transfer taxes.

Deed recordation taxes

Deed recordation taxes are imposed on the privilege of transferring real property, or an interest therein, that is located within the taxing jurisdiction. These taxes are typically only paid when the deed or other legal document actually transferring a real property interest is recorded or executed. Currently, the District of Columbia and 37 states have some form of deed recordation taxes. In addition, many localities within these jurisdictions impose their own deed recordation taxes. These local deed recordation taxes are authorized through state statute but can be imposed through either state statute or local ordinance. Regardless, deed recordation taxes are generally administered by the respective county assessor, county recorder of deeds, or county clerk, often when the deed or other legal document is recorded. These local deed recordation taxes can vary greatly, some being merely an additional element of the related state deed recordation tax while others local jurisdictions have their own deed recordation taxing regimes (such as New York City).

Controlling interest transfer taxes

Controlling interest transfer taxes are imposed on the privilege of transferring a controlling interest in a legal entity that directly or indirectly owns real property located within the taxing jurisdiction. Currently, there are over 16 major state and local jurisdictions that have some form of controlling interest transfer taxes. In addition, some other localities impose their own form of controlling interest transfer taxes.

Determining if a controlling interest transfer tax applies can be more difficult since each jurisdiction determines which transfers and which entities are subject to the tax. The definition of the controlling interest that must be transferred to trigger a tax varies from jurisdiction to jurisdiction. When 50 percent or more of the ownership interest in the entity is transferred, the controlling interest transfer tax is triggered in some jurisdictions such as New York State; meanwhile, more than 50 percent of the ownership interest must be transferred to trigger the controlling interest transfer taxes in other jurisdictions such as Illinois. While these types of 50 percent thresholds are common, there are some jurisdictions that have percentage thresholds that are significantly different. There is a similar variety from jurisdiction to jurisdiction as to which entities are subject to controlling interest transfer taxes. In some jurisdictions, any entity that holds a direct or indirect interest in real property located within the jurisdiction will be subject to the controlling interest transfer taxes. Meanwhile, in other jurisdictions an entity will only be subject to the controlling interest transfer tax when it meets certain specified criteria. These criteria can vary greatly, but include tests such as measures of real estate related assets and/or income in relation to total assets and/or income.

Aggregation of transfers

Most jurisdictions also have some form of aggregation rules that look to combine multiple transfers occurring within a specified time period together thus meeting the controlling interest transfer tax threshold even though none of the transfers would have triggered the tax independently. These aggregation rules vary from a maximum look-back period as short as six months to as long as three years but can be indefinite in cases where the transactions were undertaken with the intention of avoiding taxes. The types of transfers that are aggregated under these rules can also vary by jurisdiction. In New York State, transfers are per se aggregated for the purpose of the controlling interest transfer tax when a person, entity, or a group of people and/or entities acting in concert, transfers or acquires a controlling interest in separate transactions occurring within a three-year period. Alternatively, in New York City, there is a rebuttable presumption that transfers will be aggregated when a person, entity, or a group of people and/or entities acting in concert, transfers or acquires a controlling interest in separate transactions occurring within a three-year period. In both of these contexts, two parties are acting in concert when one can exercise influence or control over the actions of the other or if the two parties have negotiated the transfers such that they are acting as a single entity.

In the real estate investment context, it is important to understand how promotes can interact with these aggregation rules. Whether triggering a promote and causing an interest to transfer to the managing entity will count as a transfer of the ownership interest for controlling interest transfer tax purposes may differ from jurisdiction to jurisdiction. In addition, since promotes are typically less than 50 percent, controlling interest transfer taxes are usually not implicated when a promote is triggered. However, since an interest transferred pursuant to a promote being triggered can be taken in the aggregate with other transfers of ownership interests within the specified aggregation period, it is important to understand how the local jurisdiction views such transfers.

Tax rates

Transfer taxes are imposed at a percentage rate or as an amount due per every so many dollars of taxable base (usually in 100 dollar, 500 dollar, or 1,000 dollar increments). The combined state, county, and local tax rates can vary from as low as a fraction of one percent to as high as five percent. In some states, the tax imposed is uniform across the state with the tax collected being allocated between the state, county and/or locality. In other cases, there is a uniform state tax rate but with varying local tax rates. Still in other cases, there are special state tax rates that apply to specific local jurisdictions. For example, generally in Florida the tax rate is 70 cents per every 100 dollars of taxable base regardless of the location of the property. However, in Miami-Dade County this rate is reduced to 60 cents per every 100 dollars of taxable base with an additional local surcharge of 45 cents per every 100 dollars of taxable base imposed on each taxable transfer. There can also be a variation between the deed recordation tax rate and controlling interest transfer tax rate depending on the jurisdiction.

Tax base

Generally, real estate transfer taxes are imposed on the actual consideration paid for the real property that is being transferred. The taxable consideration can be inclusive or exclusive of the underlying indebtedness on the property being transferred depending on the taxing jurisdiction. For example, in California the state real estate transfer tax and many of the local real estate transfer taxes are based on the consideration paid less any underlying indebtedness on the property being assumed, which can result in a significant decrease in the transfer tax owned. In some cases when there is no or nominal consideration transferred, the taxing jurisdiction will look to the fair market value of the property as the tax base rather than consideration. For instance, generally when a property is transferred in Nebraska for no consideration, the transfer tax will be applied on the fair market value of the property. However, if the value of the indebtedness on the underlying property being assumed is equal to or greater than 20 percent of the fair market value of the property, then the value of the indebtedness will not be deemed nominal and thus the tax will apply to this amount rather than the fair market value of the property. Additional concerns can arise when determining the taxable base when dealing with controlling interest transfers especially when portions of the consideration are not specifically allocated to the underlying property. Jurisdictions have varying rules as to how to determine the taxable base in these situations, in some cases focusing on a scaled fair market value or scaled assessed value rather than actual consideration.

Exemptions

Each jurisdiction provides circumstances when the deed recordation tax and/or controlling interest transfer tax would not apply. While these exemptions can vary widely from jurisdiction to jurisdiction, the most common exemption is related to transfers that constitute a mere change in form of ownership. This exemption applies when there is a transfer but the ultimate ownership of the real property or ownership interest being transferred remains proportionately the same both before and after the transfer in question. In jurisdictions that do not shift to fair market value as a tax base when there is no consideration, there is another de facto exemption that applies to transfers of real property for no consideration because the taxable base is zero dollars resulting in no tax due.

Some other common exemptions include deeds transferred in lieu of foreclosures, transfers to government entities, and transfers effectuated by a legal orders. It is important to note that some exemptions may apply to deed recordation taxes but not controlling interest transfer taxes or vice versa.

Compliance issues

Most jurisdictions require documentation and/or payment to be submitted to the county assessor, the county recorder of deeds, or the county clerk. Many jurisdictions have dedicated forms for reporting and paying real estate transfer taxes while others require the details of the transfer and the tax due to be reported directly on the deed being recorded. Some jurisdictions require documentation and payment to be submitted at the time the deed is recorded; whereas, other jurisdictions do not require the submission of this documentation and payment until a specified number of days after the transfer or by a certain day during the month following the month of the transfer.

The party or parties who are liable for transfer taxes by default are often specified in the state statute or local ordinance, but in certain cases local custom dictates liability. However, the parties can usually negotiate around this default liability designation. Examples of default liabilities standards include the following: (1) the seller is liable for all transfer taxes; (2) the seller is primarily liable for all transfer taxes, but the buyer is jointly and severally liable if the seller does not pay; (3) the buyer is liable for all transfer taxes; and (4) the seller and buyer are liable for equal shares of the transfer tax. It is important to note that default liability can be different at the local level than at the state level. Penalties for late payments and/or late filings are not imposed in many jurisdictions because the local office will not record the underlying deed without the proper documentation and/or payment. In other jurisdictions, penalties are only applied when the taxpayer willfully, knowingly, or fraudulently reports inaccurate information. In the jurisdictions that do apply penalties more generally, these penalties can manifest as fixed penalties, fixed percentage penalties of tax due, and fixed percentage penalties of total consideration, among other forms.

Sean Kanousis is a Principal in PwC's SALT practice
He can be reached at
sean.richman.kanousis@us.pwc.com

Adam F. Robbins is a Senior Associate in PwC's SALT practice
He can be reached at
adam.f.robbins@us.pwc.com

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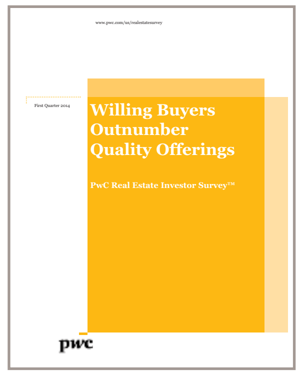

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PwC Real Estate Contacts

Byron Carlock
US Real Estate Leader
(214) 754 7580
byron.carlock.jr@us.pwc.com

Tim Conlon
US Real Estate Clients and Markets Leader
(646) 471 7700
timothy.c.conlon@us.pwc.com

Richard Fournier
US Real Estate Assurance Leader
(617) 530 7168
richard.e.fournier@us.pwc.com

Mitch Roschelle
US Real Estate Business Advisory Leader
(646) 471 8070
mitchell.m.roschelle@us.pwc.com

Paul Ryan
US Real Estate Tax Co-Leader
(646) 471 8419
paul.ryan@us.pwc.com

Christine Lattanzio
US Real Estate Tax Co-Leader
(646) 471 8463
christine.a.lattanzio@us.pwc.com

Editorial Board

Brian Ness
Partner, Real Estate
Assurance Practice
(646) 471 8365
brian.ness@us.pwc.com

Justin Frenzel
Manager, Real Estate Assurance Practice
(646) 471 5627
justin.w.frenzel@us.pwc.com

Martin Schreiber
Partner, Financial Instruments, Structured Products
and Real Estate Practice
(646) 471 5489
martin.j.schreiber@us.pwc.com

Jay Weinberg
Manager, Financial Instruments, Structured Products
and Real Estate Practice
(646) 471 0323
jay.weinberg@us.pwc.com

James Guiry
Principal, Real Estate Tax Practice
(646) 471 3620
james.m.guiry@us.pwc.com

Amy Shanaman
Manager, Real Estate Tax Practice
(646) 471 2591
amy.shanaman@us.pwc.com

www.pwc.com/us/realestate