# US Real Estate Insights

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Spring 2015

## *Dear Clients and Friends,*

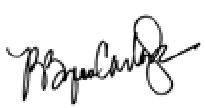
On behalf of PwC's Real Estate Practice, it is our pleasure to offer another edition of US Real Estate Insights. This publication provides perspectives on the latest market and economic trends, regulatory activities and legislative changes affecting the real estate industry, as well as informed views of the most current developments in operations, business strategy, taxation, compliance and financing.

Consistent with our global vision statement – to build trust and work toward solutions to the world's biggest problems – we continue to bring you thought leadership that is relevant to your industry, while also speaking to your topical needs related to accounting and financial trends and updates.

In this edition of US Real Estate Insights, we are especially pleased to feature an article that expands on the trend of US investors deploying capital in foreign markets, as well as the effect of changing demographics on the real estate investing landscape. In "Real Estate: Building the future of Africa," Ilse French discusses how certain demographic, economic, and political trends in Africa may impact opportunities for real estate investors. Additionally, we have included articles in this edition that continue to address your financial reporting and regulatory needs.

If you have not done so already, 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 your convenience, we have included a link to a short survey in the email communication for you to provide your feedback. For more information or to be added to our distribution list, please feel free to contact the authors of this edition's articles or your local PwC representative.



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# *Real Estate: Building the future of Africa*

*by Ilse French*

*The following is a summary of the results from the PwC South Africa publication, "Real Estate: Building the Future of Africa."*

Global megatrends, such as rapid urbanization and demographic changes, may lead to substantial growth in the global real estate industry over the next five years. Opportunities in the industry may surge, which may result in additional assets invested in the sector. These are some of the major findings of PwC's ***Real Estate 2020: Building the future report.*** But how will these megatrends impact the hugely diverse sub-regional and national markets on the African continent?

It would be easy to underestimate the impact of global megatrends on Africa. After all, Africa's real estate markets have traditionally lagged behind developed and many developing economies. Levels of investment in real estate in Africa are low by a global standard, while significant challenges exist in exploiting potential opportunities.

However, PwC South Africa's research suggests the impact of global megatrends on Africa may be significant. In ***Real Estate: Building the Future of Africa*** we consider their impact on the African continent.

Below is a summary of how these trends may impact Africa.

***Africa's young population may drive the demand for real estate and different types of real estate. Across Africa there is expected to be continued urbanization, an expansion of current cities and the rise of new cities.***

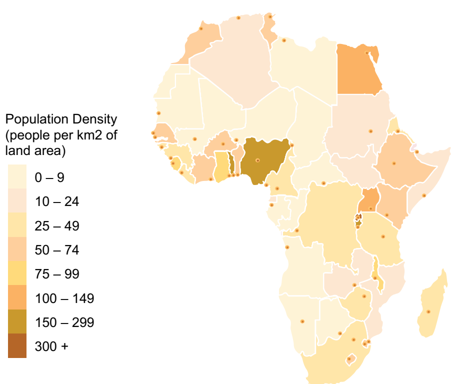
According to the World Bank, Africa's median age was 19.7 years in 2012, and it is expected to increase to 25.4 years in 2050, making Africa the continent with the youngest population. The global megatrend relating to ageing populations and the consequent increase in the demand for retirement homes is therefore not expected to have a significant impact in Africa by 2020. Projections suggest that in 2015 the continent may have a population of 226 million aged between 15 and 24 years.[1] This is expected to double by 2045.[2] This

1 UN Data. "Population Aged 15-24 (in Thousands.)" Data.UN.org. The United Nations, 20 Aug. 2013. Web. <http%3A%2F%2Fdata.un.org%2FData.aspx%3Fd%3DPopDiv%26f%3DvariableID%253A21>

2 African Economic Outlook. "Promoting Youth Employment in Africa (2012)." African Economic Outlook. African Economic Outlook, 19 May 2014. Web. http://www.africaneconomicoutlook. org/theme/youth_employment/

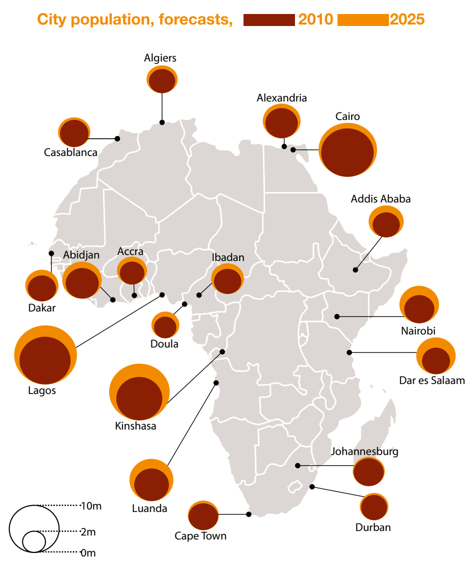
young population is expected to drive growth in the demand for housing. This may include new or emerging residential subsectors, for example student housing.

Africa is the world's second-largest and second-most populous continent with 30.2 million $km^2$ or 20.4% of the total global land area. Mauritius is the most densely populated country on the continent with 639 people per $km^2$ [2,3] while Namibia is the least densely populated with three people per km. The figure below shows the diversity of population density in Africa:




***Source**: World Bank's World Development Indicators*

Continued urbanization may have a major impact and it is estimated that the urban population in Africa will increase to 56% in 2050, making it the most rapidly urbanizing region in the world.[4] The figure below shows the estimated urban population of a selection of African cities by 2025, compared to 2010:




***Source**: United Nations Population Division, World Urbanisation Propectus, the 2014 revision*

The UN expects the fastest-growing urban agglomerations across Africa to be medium-sized cities and cities with fewer than one million inhabitants.[5] The unprecedented shifts in demographics will likely affect the demand for real estate fundamentally. In the residential sector, growing urban populations may increase demand for affordable housing, while a burgeoning middle-class may drive demand for more mid-range properties. While office, industrial, retail and residential are expected to remain the dominant sectors, affordable housing, agriculture, healthcare, retirement and mixed-use properties may become significant sub-sectors in their own right.

### *Industrialization is expected to continue across Africa and may be accompanied by a rapid growth in the retail sector.*

Reports suggest that industrialization will be funded by foreign investors, such as China. Intra-African trade and investment is expected to continue to be an important driver of growth, as high-profile local companies expand into regional markets. We expect that the retail sector will also develop rapidly as growing populations and burgeoning middle classes demand greater volumes of more varied goods. The need for economic diversification, together with growth, may support the expansion of non-resource sectors and investment opportunities may arise through an increase in demand for real estate from these sectors

### *The export of natural resources and agriculture is expected to remain a key source of economic growth and may expose certain countries to increased risk.*

Natural resources are expected to remain a major source of economic growth in Africa. New discoveries continue to drive the growth of local activity, although this continued dependency on natural resources may present both opportunities and

3 The World Bank. "Data: Population Density (people per Sq. Km of Land Area)(2013)." Data.WorldBank.org. The World Bank, n.d. Web. <http://data.worldbank. org/indicator/EN.POP.DNST?order=wbapi_data_value_2013+wbapi_data_value+wbapi_data_valuelast&sort=desc>

4 The United Nations. "World Urbanization Prospects The 2014 Revision." Esa.un.org. The United Nations, 2014. Web. <http://esa.un.org/unpd/wup/Highlights/WUP2014-Highlights.pdf>

5 The United Nations. "World Urbanization Prospects The 2014 Revision." Esa.un.org. The United Nations, 2014. Web. <http://esa.un.org/unpd/wup/Highlights/WUP2014-Highlights.pdf>

challenges for real estate developers and investors across the continent. As global demand for food grows, revenue from Africa's agricultural output may increase, while Africa's significant area of uncultivated arable land is expected to provide opportunities for growth. The risk presented by the economic fragility of commodity-exporting countries must be offset by the potential rewards from investment – either directly in helping to exploit new commodity discoveries, or indirectly through developments aimed at catering to the increased consumer demand resulting from associated economic growth.

### *Infrastructure shortages are expected to create opportunities for investment.*

Growth sectors may continue to create demand for infrastructure investment. Connections to road, rail and public transport are vital for urban success.

Doing business in Africa remains a challenge as infrastructure lags well behind the rest of the world, but there are distinct regional differences. Recent PwC South Africa research suggests that infrastructure spending in sub-Saharan Africa will exceed US$180[6] billion per annum by 2025, a growth rate of 10% per annum.[7] Major infrastructure investment programs in Nigeria and South Africa are now being accompanied by significant projects in other countries such as Ghana, Kenya, Mozambique and Tanzania. That said, a huge shortfall in government funding creates opportunities for private investors to support this development need through direct investment and public-private partnership (PPP) agreements.

### *The influence of government policy and legislation on the decision to invest may increase, while local partnerships are expected to become increasingly important.*

Increased political stability on the continent and increased participation in local partnerships may continue to ease investors' concerns relating to investing across Africa. Collaborating with governments or involving a local partner in future real estate developments in Africa are expected to become more important to mitigate the risks. Governments and the investment community are expected to have to work together to fund and build cities and their infrastructure.

### *Continued advancement within pension fund, stock exchange and banking regimes may facilitate investment, and an increased range of investors may drive demand for real estate investment opportunities.*

Development finance institutions (DFI), sovereign wealth funds (SWF) – government-run investment vehicles that manage state-owned assets – and private equity providers continue to enter the market alongside private capital and institutional investors, while developers and investors may find raising capital in the markets easier as the local financial apparatus develops. With interest from a range of investor classes and expected attractive returns, competition for prime real estate and infrastructure assets may increase.

### *Technology is expected to impact business and building practices as well as consumer behavior.*

Online technology is already having a significant impact on the finance and banking industry across Africa with the rise of mobile banking. However, the full impact of technology on real estate in Africa may only be felt in the medium to long term, as access to technology increases across the continent and the traditional consumer culture in Africa begins to change. Innovative and low-cost building technologies may also help make housing affordable.

### *Sustainability may become entrenched in building design and occupier requirements, with Africa's most ambitious countries changing city design and building practices.*

Research has shown that in certain countries where new cities are being built, developers are using eco-friendly technologies to reduce their environmental impact. Some of these technologies include solar building integration, climate responsive building strategies, renewable building materials, recycling, ecological building materials, an integrated planning process, low-cost design and the use of innovative design tools, as can be seen in One Airport Square in Ghana. This trend is expected to continue in Africa, albeit at a slower

6 Local currencies were converted to US dollar (US$) and are approximate

7 PwC LP and Oxford Economics. "Capital project and infrastructure spending: Outlook to 2025 – Region Highlights," PwC.com. Web. <http://www.pwc.com/gx/en/capital-projectsinfrastructure/publications/cpi-outlook/regionalhighlights.jhtml>

pace than in the developed world. Konza City in Kenya, Eko-Atlantic in Nigeria and Roma Park in Zambia are just a few of the entirely new urban villages focusing on the concept of 'place making' in a sustainable way. Use of these new technologies may be accelerated by new sustainability legislation in the most progressive African markets.

## Risks of investing in Africa

New risks may emerge together with the rewards attributed to the new risks. Africa has 54 very different countries with low economic connectivity between them, and there is no single answer for 'which countries to invest in'. Some of the additional risks of real estate investment in Africa include:

- The impact of political stability and changing government policy;
- A lack of economic diversity, with an overdependence on natural resources;
- Complex legal considerations, such as property ownership rights and investment restrictions;
- The volatility of local currencies against the US dollar;
- Timeframe of investments and restrictions on possible exit strategy (e.g., limited institutional investors as compared to more developed markets).

It is important that investors give consideration to these risks when investing in Africa.

## Why Africa?

Despite these risks, real estate investors and developers continue to see the African market as an attractive opportunity.

Investment returns from real estate in Africa's rapidly expanding economies significantly exceed those achievable in almost all developed markets. Forecasts of 20% net annual returns[8] from investing in shopping malls, office blocks or industrial complexes in countries across Africa continue to draw in new investors.

The opportunities across Africa appear to be significant and span every sector. In almost all markets, demand for high-quality retail, office and industrial space continues to outstrip supply as international and local occupiers respond to new economic opportunities. Huge shortfalls in residential property across the continent are expected to give rise to opportunities for private development on a grand scale, while a lack of local funding for infrastructure projects is expected to provide a platform for new private partnerships with the public sector.

Demographic shifts and changes in consumer behavior are expected to create demand for different types of real estate, allowing the entry of more specialist investors into the market.

Economic growth, improving political stability and ongoing investments in infrastructure are opening previously inaccessible markets, while increased transparency and availability of local partners is helping to improve the ease of doing business. Barriers to local market entry may be high, but by entering the market early, investors may be able to reap the rewards in the form of high returns and exploit new opportunities as they arise.

African opportunities can be embraced best by combining the competitive advantage of individual countries into a coordinated business model. For example, such a model might combine developed South African capital markets with high retail growth in less developed countries.

Risk appetite remains an important consideration for any investor in Africa, but for those real estate companies that can accept and manage these risks, the opportunity for attractive rewards from certain real estate investments may exist.

For more information on the impact of global megatrends in Africa and the growth potential of the real estate markets in some of Africa's key regions, please see the report ***Real Estate: Building the future of Africa*** on http://www.pwc.co.za/en/publications/real-estate-building-the-future-of-africa-2015.jhtml

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8 Reuters. "High stakes for high reward? Real estate funds come to Africa (2014)." www.reuters.com. Reuters, 28 Aug 2014. Web. http://www.reuters.com/ article/2014/08/28/us-africa-realestate-investmentidUSKBN0GS1YI20140828

# *New leasing standard approaching the finish line*

*by Bill Staffieri*

## Update

The FASB and IASB (the "Boards") have issued two exposure drafts, one in 2010 and the latest on May 16, 2013 (the "revised ED"), and have undertaken extensive outreach. The revised ED attracted significant comments from stakeholders. Following the conclusion of the comment letter process in September 2013, the Boards began re-deliberations to address the concerns raised by stakeholders. These re-deliberations are drawing to a close and we expect final standards from the Boards before the end of 2015.

## What are some of the key provisions?

### Lease classification – Lessors

The Boards decided that a lessor should determine lease classification on the basis of whether the lease is effectively a financing or a sale (Type A lease), rather than an operating lease (Type B lease). This is consistent with the concept underlying existing US GAAP lessor accounting. A lessor would make that determination by assessing whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset.

The Boards, in light of stakeholder concerns, voted to eliminate the "receivable and residual" approach originally proposed in the revised ED. This would have treated all leases as a sale, resulting in de-recognition of the leased asset. Real estate lessors in particular voiced concern about the resulting complexity when applied to the lease of a portion of an asset (e.g., a floor of a building being leased to a single tenant). Instead, the Boards agree that lessors should continue to reflect the underlying asset subject to the lease arrangement on the balance sheet for leases classified as operating. For financing arrangements (Type A leases) or sales, the balance sheet should reflect a lease receivable and the lessor's residual interest.

With respect to the income statement, Type B leases would attract treatment similar to operating lease accounting today. For all Type A leases, a lessor will be required to apply an approach substantially equivalent to existing US GAAP sales-type or direct financing lease accounting.

### Lease classification – Lessees

For lessees, the Boards have continued to support balance sheet recognition for most leases and have retained, but clarified, previous proposals regarding how to determine whether an arrangement is (or contains) a lease. Although in agreement on how to identify a lease, the Boards have been unable to arrive at a converged proposal regarding classification, with each Board proposing different changes to the guidance proposed in the most recent Exposure Draft.

The FASB has continued to support a dual approach for classifying leases based on criteria similar to current US GAAP – rejecting classification based on the nature of the underlying asset (as had been proposed in the 2013 revised ED). The FASB will require leases to be presented as a financing (similar to capital leases today) in the income statement (referred to as a Type A lease) when (1) payments represent substantially all of the fair value of the asset, (2) the lease term is for a major portion of the asset's useful life, (3) purchase of the asset is considered a bargain, or (4) title transfer is automatic at the end of the lease. The fair value and economic life tests are expected to be similar to the 90% and 75% classification tests under existing US GAAP guidance, albeit without the bright lines.

All other leases would be classified as Type B leases, with costs presented as lease expense and recognized on a straight line basis in the income statement over the lease term. This would produce an expense recognition pattern that is similar to operating leases under current US GAAP. In contrast, the IASB has decided to require all leases to be presented as a financing given their belief that this approach is conceptually superior and easier to apply than a dual approach.

Regardless of the differences in how classification of a lease will impact the income statement, the Boards agree that on the balance sheet, lessees should initially recognize a right-to-use asset ("ROU") and lease liability based on the discounted payments required by the lease. The only exception to this presentation will be for short-term leases (i.e., a term less than one year), which would not be recognized on a lessee's balance sheet.

### Lease payments

For both lessees and lessors, it is critical to determine which payments should be included in the calculation of their respective assets, and, in the case of a lessee, the lease liability. Previous proposals prompted significant debate. The Boards voted to include all fixed lease payments in the measurement of the lessor and lessee's assets and the lessee's lease liability. For variable payments (e.g., increases in rent based on CPI), the Boards voted to include rents on the basis of the rate or index at lease commencement. The FASB decided that lease payments used to measure the right-of-use asset and lease liability would not be revisited if rate or index changes occur unless the lease obligation was required to be remeasured for other reasons. Variable payments related to the use of the asset (e.g., percentage rent on sales) would be recognized as incurred. Lessors should not reassess variable lease payments.

## What are some of the potential impacts on real estate companies?

As the lease classification for lessors regarding most of the leasing arrangements in the real estate industry is expected to remain consistent with classification under existing guidance, the current proposals have been generally welcomed by real estate companies. Certain types of leasing arrangements will be impacted by the new standard, such as ground leases, which currently receive off-balance sheet operating lease treatment for lessees. Under the new leasing standard, these leases will be reflected on balance sheet as a right-of-use asset and corresponding lease liability.

Other than lease classification, the capitalization of internal leasing costs has become a focus area. Under the current proposals, the Boards decided that initial direct leasing costs should include only incremental costs that an entity would not have incurred if the lease had not been executed (e.g., commissions or payments made to existing tenants to obtain the lease). All other leasing costs would be expensed as incurred. This would represent a significant change in current practice. The FASB decided to require a modified retrospective transition method (with specified reliefs) for existing operating leases. In order to alleviate the burden for companies that currently capitalize these costs, the FASB provided certain transition reliefs with respect to initial direct leasing costs and decided that lessors would not be required to reassess initial direct leasing costs for any existing leases. Therefore, companies would be able to continue to amortize any initial direct leasing costs that were previously capitalized and amortized prior to the effective date of the new leasing standard. This relief will allow real estate companies to avoid writing off the remaining unamortized balance of leasing costs previously deferred upon adoption.

Adoption of the new Leases standard will have a significant impact on a company's financial statements and supporting systems and controls. This will require significant effort. But it is not simply gathering the information or implementing software or processes. Companies must also consider the effort needed to weigh the benefits of the recently added transition relief options in order to develop a well thought out transition plan.

Another important focus area is consideration of the impact that the changes may have on customary commercial arrangements. Tenants may desire changes in typical lease terms or may reconsider leasing decisions as the leases are reflected on balance sheet under the new standard. Another example may include arrangements involving the construction of an asset to be leased upon completion (e.g., a build-to-suit lease transaction). Under current US GAAP, failure to comply with specific rules will result in the lessee reflecting the arrangement as if it were the legal owner of the lease asset during construction. Along with the asset, the lessee would need to record debt equal to the funding provided by parties other than the lessee. The prescriptive rules are not expected to be retained in the final Leases standard and, as such, may prompt lessors to require a lessee to assume additional construction risk or to have greater involvement in construction.

## What's next?

The Boards have nearly completed their re-deliberations and are working on drafting the final standard, which could differ in some respects from the tentative decisions discussed to date. The Boards have indicated that they will not issue another exposure draft and hope to issue a final standard in the second half of 2015. The Boards have not yet proposed an effective date.

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# *Buyers face aggressive buying environment*

*by Susan Smith*

*The following is extracted from the First Quarter 2015 issue of the PwC Real Estate Investor Survey, released on March 16, 2015. The findings and opinions reflect those of the investors surveyed and do not necessarily reflect the views of PwC.*

When asked what the most challenging aspect of the commercial real estate (CRE) industry is today, "strong competition between buyers" is the universal answer among surveyed investors as the industry's improving fundamentals and strengthening US economy cause domestic and international investors to funnel capital into CRE at a quickening pace, particularly into the office sector.

Some of the most aggressive office building buyers have been foreign investors who continue to step up their US presence in CRE. In 2014, cross-border investors accounted for 14.4% of the sales activity in the office sector, according to Real Capital Analytics. In 2009, this figure was 10.0%. Surveyed investors expect both Chinese and Canadian buyers to be especially aggressive in pursuing US office assets, as well as other US CRE property types, in the near term, keeping competition intense for 2015.

With a growing pool of buyers vying for a limited number of quality deals, our Survey participants foresee little relief in pricing for all property sectors in 2015. Even though such strong buyer demand has prompted some owners to sell, others are holding assets in order to capitalize on growing tenant demand and rising rental rates and values. Looking ahead over the next 12 months, our Survey shows investors expecting (on average) the office sector to lead the industry in terms of value growth; followed by the warehouse, lodging, apartment, and retail sectors, respectively.

## Overall cap rates

In the first quarter of 2015, the average overall capitalization (cap) rate decreases in 24 Survey markets, holds steady in five, and increases in five over the past three months. The declines are diverse and spread across property sectors and locations with the national medical office buildings market and the city-specific office markets of Chicago and Seattle posting the largest quarterly drops. In contrast, average overall cap rates hold steady for the national apartment market, as well as the city-specific office markets of Dallas, Houston, San Diego, and Suburban Maryland. Overall cap rate expansion is the greatest for the national regional mall market, where vacancy has barely moved due to re-leasing challenges brought on by store closings. The Survey office markets of Boston, Southeast Florida, and Washington, DC also report overall cap rate increases this quarter.

Most Survey participants expect overall cap rates to hold steady over the next six months with the exception of the office markets of Boston, Denver, Houston, and Phoenix, where overall cap rate expectations vary between increasing, decreasing, and holding steady.

## Market rent growth assumptions

Robust trends in employment sectors that tend to influence office space consumption continue to spur leasing demand amid limited additions to supply. As a result, many property owners have been able to raise rental rates for both new office leases and renewals. For the city-specific office markets in our Survey, the aggregate average initial-year market rent change rate assumption is 2.90% for the first quarter of 2015, ten basis points above the average a year ago. While the average has remained on an upward trend for the past five years, it remains below the average seen at the peak of the cycle in 2007.

Over the past three years, the Denver office market has posted the largest gain in this key assumption, increasing 380 basis points. Investors cite Denver's diverse economy, rising tech center, and recovering housing market as reasons for its rebounding office market.

## CRE sector overviews

### Office

As a whole, leasing demand is estimated to outpace new supply in the US office sector over the next three years, resulting in rising occupancy levels that should propel it from recovery to expansion through year-end 2017. While investors expect these trends to continue to benefit many downtown office locations, they foresee an almost equally impressive outlook for many suburban office areas. This quarter, the average expected value change for the national suburban office market is 4.0% – the third highest for the Survey's national markets.

While many buyers remain drawn to infill suburban office locales, it remains difficult to find available assets in such locations and once found, pricing can be "frothy." While one surveyed investor notes that "it's a sellers' market for infill suburban properties," others agree that "regular" suburban office assets are still priced low relative to replacement cost, favoring buyers.

### Retail

In 2015, a growing number of retail metros will benefit from increasing tenant demand and limited new supply. As a result, the number of retail metros in the recession phase of the real estate cycle is expected to decline over the next three years as many areas segue from either recession to recovery or recovery to expansion.

While slow-but-steady improvement in retail fundamentals will likely increase the number of interested buyers looking for acquisitions, investors in the Survey's national regional mall market comment that few quality assets have been offered for sale. As a result, several regional mall investors anticipate fewer trades in 2015 compared to previous years.

In the Survey's national power center market, an imbalance also exists between buyer demand and quality offerings causing overall cap rates to continue to contract this quarter, slipping to 6.56% – the lowest average for this key indicator since this market debuted in mid-1996. Looking ahead over the next 12 months, our surveyed investors expect property values for power centers to increase as much as 10.00% with an average expected value increase of 2.6%.

Value expectations for the Survey's national strip shopping center market mirror those of the national power center with a slightly higher average (+ 2.7%). In addition, sales activity is not expected to increase significantly for 2015 as few quality shopping center assets are available for sale and those that are available are "priced too high," according to investors.

### Industrial

While reveling in the strong performance of the national warehouse market, investors are keeping a close watch on the burgeoning construction pipeline. According to Reis, construction levels for the US industrial sector continue to swell, reaching a post-recession high during the fourth quarter of 2014 when completions totaled 22.8 million square feet – up 85.3% from a year ago. By comparison, construction activity for all of 2012 was only marginally greater than this quarter's total.

Given the amount of new construction slated for delivery over the next several months, some investors sense that it is unlikely that vacancy rates will compress in the near term despite strong leasing trends. Nevertheless, many investors remain steadfast in their search for acquisitions. "There's still a lot of competitive capital out there, driving up prices and the need to be very aggressive to secure a quality deal," comments a Survey participant.

### Apartment

While most Survey participants believe that current conditions in the national apartment market favor sellers, potential roadblocks for investors exist in the coming year, including extreme competition for quality investments, an overabundance of available capital, and in some markets, oversupply of apartment product.

For 2015, a higher number of multifamily metros are in the contraction phase of the real estate cycle than in the expansion phase compared to last quarter's analysis. Nevertheless, there is still a tremendous amount of capital looking for apartment deals as investors remain drawn to this market's resiliency thus far.

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

# International tax updates impacting real estate investments

*by Oscar Teunissen, Sulay Sinha and Rashmi Soans*

## Introduction

In recent months, a number of tax-related changes globally were largely driven by the Organization for Economic Cooperation and Development ("OECD") which delivered eight action item reports in 2014 and several public discussion drafts aimed at combating tax avoidance by multinational enterprises as a follow-up to the Base Erosion and Profit Shifting ("BEPS") 15-key-area action plan released in 2013. A summary of some of these action items is provided below.

Taking a cue from the BEPS action plans, a number of countries have already introduced unilateral measures to widen their tax net. Introduction of anti-abuse laws along with increased tax audits are being seen. Some of these unilateral measures have been discussed below.

The European Commission has been investigating rulings provided by Luxembourg, Ireland and other European countries. This has increased the level of scrutiny and tax audits in the region. Spain has revamped its income tax law – and apart from certain limitations, has introduced various benefits as well. Further, Luxembourg has introduced changes to its tax ruling mechanism, and has amended transfer pricing provisions. India, China and Singapore have also introduced amendments in tax law.

## BEPS action plan

In February 2013, the OECD published its BEPS report highlighting the growing global perception that governments may be losing substantial tax revenues as a result of multinationals shifting corporate profits to lower tax jurisdictions. In July 2013, the OECD released an action plan with 15 separate action items to be completed over the following 18-24 months. In 2014, individual action reports were prepared for eight of the 15 action items some of which are detailed below.

### Action 2: Neutralizing the effects of hybrid mismatch arrangements

A hybrid mismatch arrangement is a profit shifting arrangement that utilizes a hybrid element in the tax treatment of an entity or instrument to produce a mismatch in tax outcomes in respect of a payment that is made under that arrangement. The two key mismatch arrangements identified in Action 2 are:

- Payments that are deductible under the rules of the jurisdiction of the payer and not included in the income of the recipient; and
- Payments that give rise to duplicate deductions from the same expenditure.

The report on hybrid mismatch arrangements emphasizes that such arrangements can be used to achieve double non-taxation and as a result reduce the collective tax base of countries around the world.

Action 2 calls for new domestic provisions and changes to the OECD Model Tax Convention regarding the treatment of hybrid investments. The intention is to avoid double taxation and to ensure that the mismatch is eliminated even where not all the jurisdictions adopt the rules.

The recommendations are intended to drive taxpayers towards less complicated and more transparent cross-border investment structures that are easier for jurisdictions to address. This report also makes references to other action item, particularly Action 3 (dealing with the design of CFC rules) and Action 4 (looking at interest deductions).

### Action 4: Interest deductions & other financial payments (public discussion draft)

In December 2015, the OECD released a discussion draft on action item 4 regarding interest deductions and other financial payments. This report has come as a response to OECD's concerns that groups are being allowed to claim interest deductions in excess of their actual third party interest expenses.

Although the taxpayers suggest that the use of the arm's-length based rules may address base erosion, OECD considers that this has not been enough to tackle BEPS in the past and therefore further actions should be taken.

In the discussion draft relating to Action 4, the OECD considers two major ways to tackle BEPS in the form of interest deductions – namely, the use of fixed interest deduction ratios linked to EBITDA or Assets against the use of variable interest deduction ratios calculated by reference to a group-wide or entity-wide ratio.

### Action 5: Countering harmful tax practices

The OECD has been concerned with harmful tax practices for a number of years; in 1998, it had issued a report titled "Harmful Tax Competition: An Emerging Global Issue," following which it created a special Forum on Harmful Tax Practices. The Forum has produced several progress reports on this issue to date and it is again being called to action in the Action 5 report, which highlights that preferential tax regimes continue to be a key pressure area in international taxation.

The Action 5 report tasks the Forum with helping to improve international taxation transparency, including exchanges on rulings related to preferential regimes, and to establish substantial activity requirements for preferential regimes.

### Action 6: Preventing the granting of treaty benefits in inappropriate circumstances

Action 6 in the 2013 BEPS report proposed changes to the OECD Model Tax Convention aimed at preventing treaty abuse and specifically called for:

a. Development of model treaty provisions and also recommendations on the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances;

b. Confirmation that tax treaties are not intended to be used to generate double non-taxation;

c. Identification of key tax policy considerations for countries to consider when entering dual tax treaties.

The 2014 report on Action 6 responds to these 3 action areas. The report recommends, inter alia, the inclusion of limitation-on-benefits (LOB) provisions and principal purposes of transactions requirements in the treaties, which would be expected to address a number of treaty shopping situations based on the legal nature, ownership and general activities of residents of respective jurisdictions as well as certain conduit financing arrangements.

The report proposes the inclusion of a test under the LOB provision that countries could use to address the availability of treaty benefits to collective investment vehicles (CIVs) and other funds. The report also notes that further work is needed on implementation of the minimum standard for addressing treaty abuse and on the policy considerations relevant to treaty entitlement of CIVs and other funds.

The report further recommends that treaty language should expressly confirm that a treaty does not restrict a state's right to tax its own residents (similar to the "Saving Clause" already found in US tax treaties) or to apply departure taxes on persons or entities that cease to be residents of an applicable state. Final versions of the complete model treaty amendment recommendations are expected to be released in September 2015.

## Anti-treaty shopping and anti-abuse rules

In 2014, many countries, either unilaterally or collectively, have taken action against artificial transactions/ structures that have been set up with the sole purpose of enjoying a tax benefit granted under a tax treaty.

- On December 9, 2014, the EU Council approved the introduction of a general anti-abuse clause ("GAAR") in the EU Parent-Subsidiary Directive and requested that Member States must implement the amendment into their domestic legislation by the end of 2015. With this amendment, the EU has taken a further significant step towards preventing tax avoidance and aggressive tax planning by corporate groups.
- Russia has introduced the beneficial ownership concept for the purposes of applying the double tax treaty benefits in an attempt to attack transactions that have been structured with the sole driver of taking benefit of the Russian tax treaty network.
- Denmark also introduced new rules to combat treaty-abuse. Amongst proposed measures, the most important is the introduction of a general anti-avoidance rule (GAAR) which will apply to any foreign transactions with a Danish entity. In essence, the protection normally available to transactions under Danish tax treaties and EU Directives will no longer be available unless certain substance and commercial reasons tests are met.

## Country-specific taxation changes

### Luxembourg
### Changes in ruling procedure and transfer pricing framework

*Ruling procedure*

Effective January 1, 2015 Luxembourg introduced a number of changes to its tax law, including a new advance tax clearance ("ATC") procedure.

Pursuant to the new ATC procedure, ATC requests will be sent to a commission which will assist the tax inspector in ensuring a uniform treatment between taxpayers. Decisions will be published in a summarized way on a no-name basis in the annual report of the direct tax administration. The Luxembourg tax authorities have published guidance outlining the conditions under which a ruling can be sought.

The manner in which the new procedure will impact Luxembourg undertakings going forward should be monitored closely. This will be relevant for real estate and private equity funds.

*Transfer pricing*

The Luxembourg framework for transfer pricing has also been amended to make it more aligned to the OECD Tax Model Convention. Various disclosure and documentation requirements have been clarified.

## Spain
## Changes to tax and insolvency law

Effective January 2015, the Spanish Government overhauled the Spanish corporate income tax. Some of the amendments are relevant for investors in Spanish real estate.

Interest derived from profit participating loans (PPLs) granted by members of the same corporate group will not be tax deductible. This should not impact PPLs granted prior to June 20, 2014 (the effective date), unless the terms of PPLs existing prior to June 20, 2014, are proposed to be extended or renewed.

In line with the increased awareness on BEPS globally, Spain has introduced new rules targeting hybrid instruments. Based on the new Spanish tax framework, expenses derived from transactions with related parties will not be tax deductible, where there is a different classification of the transaction by each party, and as a result of this, any income generated at the level of the counter party is tax-exempt, subject to tax at lower than 10%, or no income is deemed to be generated. If the interest amount relates to a financial instrument that is classified as debt in Spain but has all the substantial characteristics of equity in the other jurisdiction and income from such instrument is treated as non-taxable income or income taxable at a rate lower than 10%, interest will be disallowed in Spain.

The scope of the Spanish tax framework has been amended to provide for a participation exemption in case of Spanish companies on capital gains and dividends. Capital gains on sale of shares of a Spanish property company by a Spanish holding company should be exempt under the domestic participation exemption subject to certain conditions (minimum shareholding and holding period) and provided that the Spanish property company being transferred is not considered a passive investment company.

The Spanish tax law pertaining to the domestic anti-avoidance clause for the application of the EU Parent Subsidiary Directive withholding exemption on dividends when the ultimate shareholder is resident outside of the EU requires the recipient to demonstrate that its incorporation and operations are based on valid economic grounds and substantive business reasons in order to claim any tax relief. With the emphasis on anti-avoidance provisions and the recent updates on the Luxembourg tax leaks, the Spanish authorities are getting more stringent with the conditions to claim exemption under the EU Parent Subsidiary Directive.

### *Insolvency law*

Another important development is the amendment to Spanish insolvency law which would make it easier for companies to continue as going-concerns and to avoid liquidation. The new rules in relation to debt restructuring that were passed aimed at avoiding or reducing the negative tax impact for borrowers. Even though these new rules are not restricted to the asset management industry, they are particularly important to asset managers due to the general high leverage of real estate players and the debt refinancing and debt restructuring processes common in the industry.

## China
## New framework in indirect transfer rules

Under Chinese tax law, if any arrangement is considered an abusive use of company structure without a reasonable commercial purpose, it may be subject to corporate income tax in China. In early February 2015, the Chinese tax authorities released Public Notice [2015] No. 7 ('Public Notice 7') to supersede the current Chinese tax rules in relation to the offshore indirect equity transfer. Public Notice 7 provide significant guidance to taxpayers.

Public Notice 7 extends the scope of the indirect tax rules to capture all 'Chinese Taxable properties'. The definition aims to cover within its ambit not only equity investment in Chinese properties, but also transfer of an offshore entity holding interest in an immovable property located in China.

Public Notice 7 sets out seven general criteria (including other general criteria) based on which the transferor and transferee have to make their own assessments on whether the structure has reasonable commercial purpose. Among the seven criteria in the Public Notice 7, four are classified as “Red Zone” and transfers meeting such criteria are seen as without reasonable commercial purpose; for instance, if 75% or more of the value of the offshore company is derived from China, or if 90% or more of total assets or income is derived from China.

Public Notice 7 also covers safe harbors or “Green Zone” (i.e., transfers with reasonable commercial purpose). In such cases, the offshore indirect transfer on Chinese properties should not be subject to tax in China; for instance, if the foreign transferor buys and sells the shares of the same listed overseas company through public stock exchanges.

Further, in order to qualify for safe harbor rules in the case of indirect transfer of Chinese land rich companies under internal restructuring, the shareholding relationship for the foreign transferor and transferee should be 100%. In addition, the internal restructuring would not result in a reduction of corporate income tax burden on the gain arising from the subsequent potential indirect transfer and the transfer consideration should be settled in a form of equity (not including the equity of listed enterprises) of the transferee or its subsidiaries.

The manner of practical implementation by local tax authorities relating to Public Notice 7 will be seen soon.

## India
## Introduction of REITs and other recent changes in law

*Indian REITs*

In August 2014, India’s securities regulator approved the new Real Estate Investment Trusts (REITs) Regulations which aim to provide a regulated platform for investment in stabilized real estate assets in India. Indian REITs must be structured like other trusts requiring, amongst others, a sponsor and a trustee, and must comply with key investment conditions, including permitted types of investments, ownership lock-in periods, borrowing levels and mandatory income distributions.

Investments in Indian REITs are expected to be favored by non-residents. However, the tax framework so far does not appear to be appear to be beneficial for foreign investors in REITs (where REIT in turn have equity holding in property companies), as distributions to non-resident investors may be taxed at an effective tax rate of as high as 40%. While there may be avenues to improve the tax rate by the use of leverage, there are practical challenges in implementing such structures. Moreover, regulatory amendments to permit foreign investment in Indian REITs are still awaited.

*Indirect transfers*

Investments in India are typically made using treaty platforms such as Mauritius, Singapore, which protect capital gains upon exit. However, distribution of cash from Mauritius and Singapore SPVs to Fund entities and ultimately to the investors in the Funds could trigger Indian indirect transfer rules if the capital of the offshore entities is redeemed/reduced at a premium. The potential impact is that gains could be taxable up to 43%.

Given this, for existing structures, it is important to determine whether capital is likely to be redeemed/reduced by an entity holding Indian assets and assess the impact of the indirect transfer taxation provisions. Further, new structures for future investments into India should also be evaluated in light of the potential impact of indirect transfer provisions in upstreaming cash.

*Residency of foreign company*

The tax residency test in India for foreign companies is proposed to be changed, and from April 1, 2015, a foreign company could be considered a tax resident of India if its place of effective management (“POEM”) at any time in that year is in substance in India. This is distinct from the earlier Indian tax residency test which required the control and management of foreign companies to be situated wholly in India during the relevant year. If a foreign company becomes a tax resident of India, its global income should be taxable in India at the rate of about 43%.

*General Anti-Avoidance Rule*

The introduction of GAAR has recently been deferred for 2 years and should apply from April 2017. Investments made before 1 April, 2017 are proposed to not be subject to GAAR.

## Ireland
## Irish capital gains tax relief on land or buildings acquired before December 31, 2014; Loan Origination in Irish Funds; introduction of the ICAV corporate vehicle

*Irish capital gains tax relief on land or buildings acquired before December 31, 2014*

Ireland had previously introduced a relief from capital gains tax on disposals of land or buildings that were acquired in Ireland (or, for purposes of domestic Irish taxation, in any European Economic Area State) between 7 December 2011 and 31 December 2013. The acquisition period for purposes of this relief was extended to 31 December 2014 but has now expired. The interesting point to note in relation to this legislation is that Irish Revenue published an briefing in December 2014, clarifying that enhancement expenditure incurred any time on land/buildings purchased in the period between 7 December 2011 and 31 December 2014 (including expenditure on construction of buildings on land or completion of partially built buildings) does not impact on the entitlement to the CGT relief. If held for a period of 7 years, property is expected to qualify for full relief on any gain arising on disposal. Partial relief from tax is expected for property held for more than 7 years. The intention of this relief is to help stimulate activity in the property market.

The latest Finance Act (Finance Act 2014) enacted included an amendment to the Irish REIT regime to prevent a capital gains tax free intra-group transfer of Irish real estate to a REIT. The aim of this measure was to ensure that a capital gains tax charge arises as Irish real estate moves into the REIT regime.

*Loan Origination in Irish Funds*

Another interesting development that should help the investment initiative in Ireland is the July 2014 proposal by the Central Bank of Ireland to allow Irish Alternative Investment Funds (AIFs) to originate loans. Loan origination by AIFs will be subject to additional AIF regulation aimed at ensuring a stable financial environment and investor protection. This has been a welcome announcement for asset managers who have been seeking alternative lending structures to mitigate the impact of the funding gap in Europe arising from the de-leveraging of banks.

*Introduction of the ICAV corporate vehicle*

In March 2015, the Irish President signed into Law the introduction of the Irish Collective Asset-management Vehicle (ICAV). The ICAV is a new corporate vehicle and it increases the range of fund vehicles in Ireland available to promoters, fulfilling one of the initiatives outlined in the Irish Government's IFSC Strategy 2011-2016.

## Germany
## Transfer tax on indirect change in ownership of a partnership owning real estate

An indirect change in a property owning partnership may trigger real estate transfer tax (RETT). The Supreme Tax Court, in its April 2013 decision granted a taxpayer's appeal – against the opinion of the finance ministry – on the grounds that an indirect change in the shareholdings in the members of a property owning partnership was less than a complete change of interest in the partnership. RETT is due if at least 95% of the ownership interests in a partnership change over a five year period. The change can be direct or indirect. On this basis, the tax office raised a RETT assessment on a partnership of two partners after the ultimate holding company of a 6% partner sold 50% of the shares in its immediate subsidiary to a third party following the transfer of the 94% partnership interest by the other partner to a different third party. The tax office contention was that the effective composition of the property owning partnership had changed by more than 95%, taking both changes together. This was then rejected by the Supreme Tax Court.

It is now planned to reinstate the former view of the tax authorities and to amend the Real Estate Transfer Tax Act accordingly. The date of implementation would be after proclamation of the amendments in the Federal Gazette.

## France
## Changes in the treaty with Luxembourg; capital gains taxation of non-residents; challenge to tax on dividend distributions

*France-Luxembourg tax treaty change in the taxability of shares held in land-rich companies*

In September 2014, the Finance Ministers of France and Luxembourg signed a Protocol to the France-Luxembourg double tax treaty to amend its provisions to give taxing rights on gains arising from disposal of interests in real estate-rich companies solely to the state in which the underlying real estate is situated. Immovable property attributable to the activities of the company's business enterprise (other than real estate businesses) will remain exempted from the gains tax. The Protocol will come into force after approval by the respective Parliaments, ratification by the Government, on the first day of the month following the last exchange of diplomatic note by Luxembourg or France. The new Treaty wording is in line with the wording of most of France's other tax treaties.

While the Protocol applies equally to France and Luxembourg, in practice, the great majority of affected disposals will concern French real estate. The Protocol makes no distinction between private and public shares; however, it is notable that under French domestic rules, capital gains realized by non-residents upon the disposal of shares in French real estate vehicles (SPPICAVs and listed SIICs) should remain exempt from French taxation if the seller holds (directly or indirectly) a stake of less than 10%.

*Reduced real estate capital gain tax rate for certain non-residents*

Capital gains derived from the disposal of real estate assets located in France or derived from the disposal of French real estate shares or interest are now subject in France to a reduced withholding tax rate of 19% (33.33% previously). The 19% rate applies to non-resident individuals and individual investors in flow-through entities. Several exceptions apply especially with respect to non-resident domiciled taxpayers or those established in non-cooperative states and territories. This new rate applies to capital gains triggered on or after January 1, 2015.

*European Commission challenges France's 3% tax on dividend distributions*

The European Commission has launched an infringement procedure against France regarding the 3% tax on dividend distributions that entered into force in 2012. The 3% tax applies to dividends and other distributions (including deemed dividends for French tax purposes) paid by French companies or French branches of non-European Union (EU) companies. Asset managers doing business in France should consider filing a refund claim for any 3% tax they have paid. However, it is important to be aware that the Commission may ask France to amend the legislation to comply with EU law, rather than simply repeal it.

## Singapore
## Recent budget announcements

The Singapore Budget 2015 was announced on February 23, 2015, and there were a few important announcements for real estate funds and their managers.

Under the Singapore fund incentive schemes while previously only the main fund might have obtained a tax exemption, its subsidiaries ('SPVs') were not automatically exempted. Based on the Budget announced, effective from April 1, 2015, it seems that funds approved under the relevant incentive schemes can now obtain tax exemptions for their SPVs as well. However, it is expected that the conditions may be tweaked to be a bit more extensive in order to include the exemption for the SPVs. Further details are expected to be released by the Monetary Authority of Singapore (MAS) by May 2015.

Various REIT tax concessions that were previously due to expire in March 2015 have been extended to March 31, 2020. These concessions include (i) tax transparency for REITs listed on the Singapore Exchange if the trustee distributes at least 90% of its taxable income in the year in which the income is derived; (ii) tax exemptions from qualifying income; (iv) concessionary tax rate of 10% for non-resident, non-individual investors in listed REITs; and (v) Goods and Services Tax (GST) remissions. Note that stamp duty remissions on the transfer of certain properties by listed REITS are due to expire in March 31, 2015 and will no longer be available thereafter.

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