US Real Estate Insights

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Dear Clients and Friends,

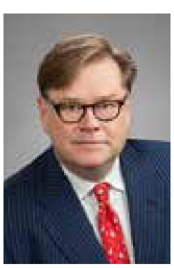
On behalf of PwC's Real Estate Practice, it is our pleasure to offer another edition of US Real Estate Insights. This publication provides perspectives on the latest market and economic trends, regulatory activities and legislative changes affecting the real estate industry, as well as informed views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

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. 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.

In this edition of US Real Estate Insights, we continue to build on the theme of investing globally and are especially pleased to provide an article that discusses the flow of capital into US markets from foreign investors. In "The New Sources of US Real Estate Capital," Jack Keating discusses which nations have been investing in the US markets and the challenges these investors face as they increase their allocations to US markets.

Additionally, recent newspaper headlines have been dominated by news of cyber security breaches that have affected corporations and governments. To help address your organization's cyber security, in "Growing Concerns over Cybersecurity in the Real Estate Sector," Amandeep Lamba discusses how these threats can impact real estate companies and in turn, how these companies can increase their cyber security resilience.

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. Also, stay tuned for our upcoming publication, *Emerging Trends in Real Estate*. We hope you will find US Real Estate Insights to be informative and helpful to you in your business. As always, we encourage you to share your thoughts, opinions and suggestions. For more information or to be added to our distribution list, please feel free to contact the authors of this edition's articles or your local PwC representative.



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The new sources of US real estate capital

by Jack Keating

After years of an export-driven economic boom, the 1980s saw Japanese investors plough investment into the US commercial real estate market in record breaking numbers. US investors asked a number of questions about these new buyers of luxury condos, Rockefeller Center and the famed Pebble Beach golf course. The same questions are now being asked of a number of new foreign entrants to the US market today.

How much are foreign investors buying?

Since the bottom of the market in 2009, foreign buyers of US commercial real estate have increased their annual purchases by more than 900% to nearly $48 billion in 2014.[1] While this is record breaking transaction volume, foreign buyers make up less than 15% of the annual US commercial real estate market.[2] Compare this to the UK, where foreign investors also purchased nearly $48 billion in 2014 in a market that is only about a quarter of the size of the US.[3]

1 Real Capital Analytics – Investor Universe, Retrieved May 19, 2015.

2 Id.

3 Id.

Still, foreign volumes are growing quickly in the US and these investors are increasing in sophistication. Moreover, their commitment to the US market may be more than in previous cycles, with a number of foreign investors establishing teams on the ground with experienced Americans staffing the offices.

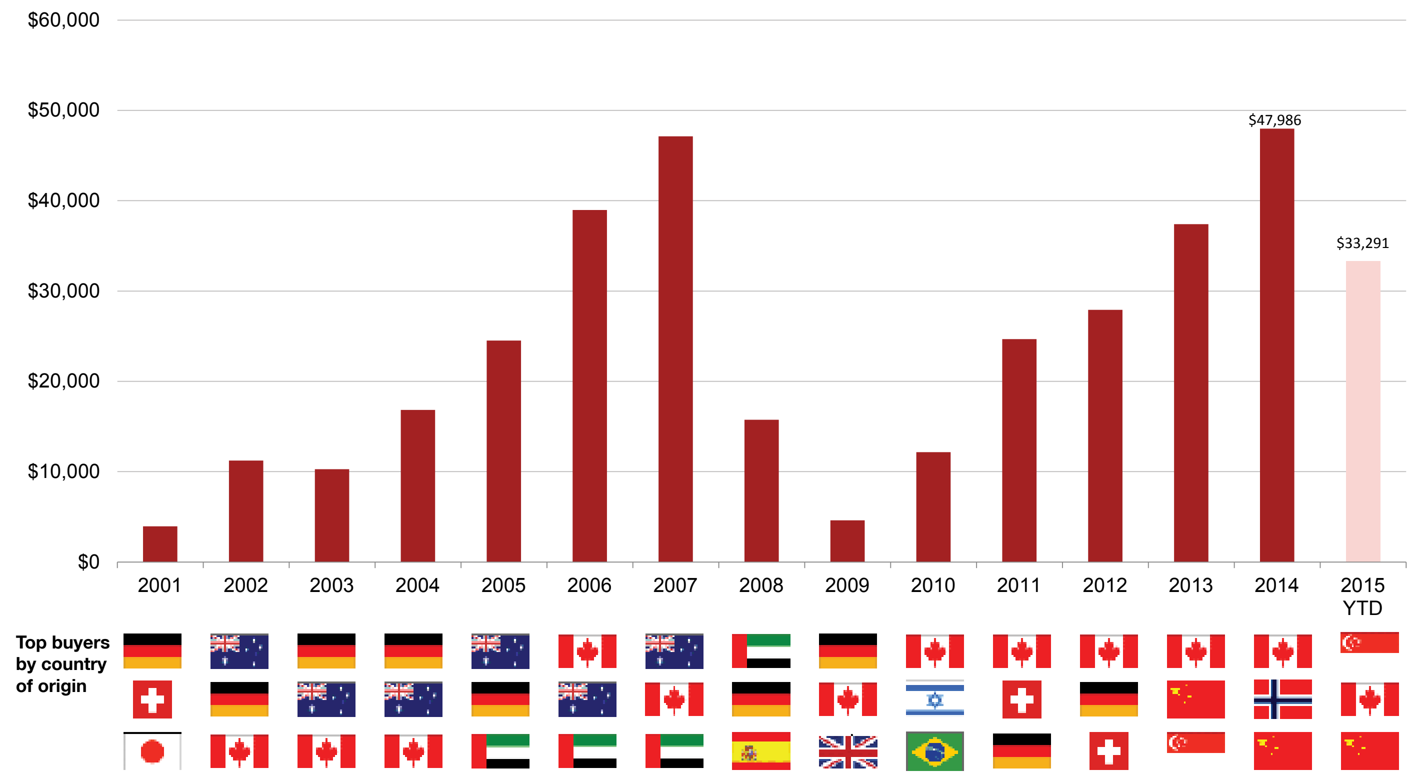
Who are these investors?

Based on headline deals and discussion among industry participants, the perception is that giant Middle Eastern and Asian investors backed by their own governments are gobbling up property around the US. In reality, western investors from developed economies still tend to dominate the tables of US commercial real estate investment volumes.

Canadian investors and pension funds comprised four of the top ten foreign investors in the US over the past five years and Canada was the number one source of foreign capital acquiring US property from 2010 to 2014.[4] Canadian investors have a unique advantage in the US due to both their proximity to the market

4 Real Capital Analytics – Cross-Border Capital Tracker, Retrieved May 19, 2015.

Figure 1: Volume of foreign real estate investment in the US ($m)



Source: Real Capital Analysis. 2015 YTD figures as at 5/19/2015.

and experience investing in the US. Canadians began investing in the US long ago due to the relatively small size of their own markets. This has led to a high level of US real estate expertise within the major Canadian investment funds and deep relationships that create deal flow.

Likewise, as seen in the chart above, Western European investors including Germany, Switzerland and Norway have been active in the US over the past five years. Like the Canadians, these investors have long history in the US, with established relationships and investment teams on the ground in the major US markets that makes it easier for them to find, win and close real estate deals. Perhaps surprisingly, UK investors are not as active in the US as might be expected. Over the past five years, only one UK investor ranked among the top 40 buyers of US commercial real estate.[5]

Comparatively, high profile investments in the Waldorf-Astoria in Manhattan and the Atlantic Yards project in Brooklyn lead many to conclude that mainland Chinese investors are scooping up US property like the Japanese did in the 1980s. However, the majority of investment from Asia has come from the more developed economies of Singapore, Hong Kong and Korea.[6] Capital coming from mainland China has primarily come from "private" sources (by Chinese standards) such as corporations and individual investors, as the large Chinese Sovereign Wealth Funds ("SWFs") have shown very limited interest in closing direct US real estate investments.

Alternatively, according to Real Capital Analytics, Middle Eastern investors were among the top investors prior to the global financial crisis, with investors from the United Arab Emirates purchasing nearly $11 billion in US real estate between 2001 and 2007.[7] This made the UAE the fourth most active country of origin over that time. However, they have had dampened appetites since then relative to other countries. From 2008 to 2014, for instance, capital from the UAE acquired only $7.5 billion of US real estate.[8] While some of the larger Middle Eastern SWFs remain active, concerns around the falling price of oil raise the question of whether the region as a whole will keep pace with their Canadian, European and Asian peers.

5 Id.

6 Id.

7 Id.

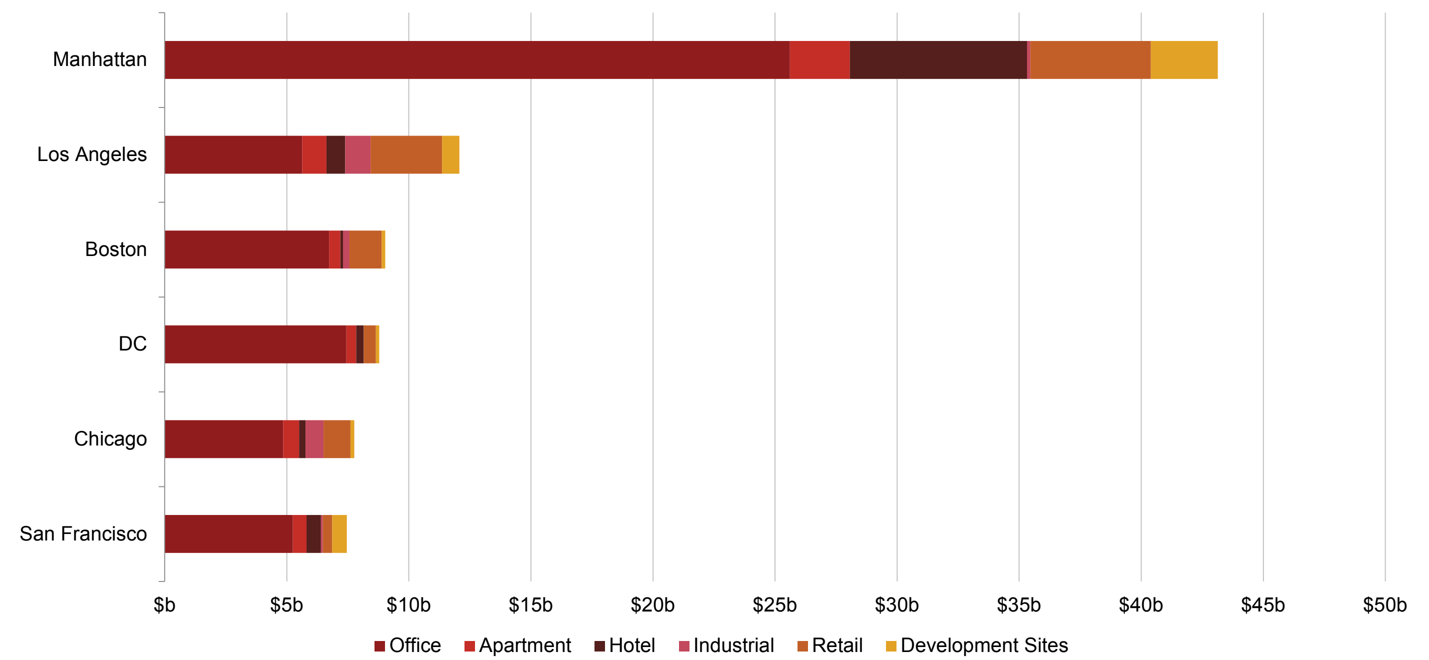
8 Id.

What and where are they buying?

Foreign investors favor the large gateway markets that domestic US buyers also target. Manhattan is far and away the most targeted market by foreign buyers, taking in more than $43 billion in capital over the past five years. Comparatively, Los Angeles ranked second in investment, with approximately $12 billion in capital investment.[9] Outside of the top six cities shown in the table below, anecdotal evidence suggests that foreign investment in secondary and tertiary markets in the US is more tactical. Without investment teams on the ground and strong relationships in these cities foreign investors may struggle to close good deals. And many of these markets are simply smaller than foreign investors are comfortable with.

Core office properties are far and away the preferred targets of foreign buyers, making up more than 40% of all foreign investment volumes over the past five years.[10] Retail assets also attract attention, but foreign investors prefer the top gateway markets on the coasts. This is in contrast to apartments, where only 21% of foreign purchases in the past five years took place in the top six US markets.[11] In the coming years, investors are expected to watch trends regarding foreign capital flow, including if foreign buyers begin to venture more into those secondary and tertiary markets as pricing and competition in the gateway cities continue to rise.

Figure 2: Foreign commercial real estate investment volumes (5 years to May 2015)



Source: Real Capital Analytics.

9 Id.

10 Id.

11 Id.

What challenges do foreign investors face in the US commercial real estate market?

The tax effects of transactions are typically one of the areas of focus in most US real estate deals. To this end, foreign buyers can face a number of obstacles their American competitors do not. The Foreign Account Tax Compliance Act ("FATCA") and the Foreign Investment in Real Property Tax Act ("FIRPTA") are highly complex and have large implications for foreign investors, both in terms of tax payments and the sometimes costly and time consuming tax structuring, monitoring, reporting and due diligence that go with them.

SWFs and other investors tied to foreign governments can qualify for US tax immunity under Section 892 rules. However, in order to do so, these investors must be passive, minority investors. This can create an added real estate investment burden of identifying and building relationships with investment partners and taking a passive role in asset management. These foreign investors do not face the same restrictions in other global real estate markets, which may diminish the attractiveness of US real estate investment opportunities.

Also, foreign buyers may face increased scrutiny and in some cases government involvement, especially in high profile deals. This can create undesirable media attention and added costs to deals. For example, after the Chinese insurance company Anbang agreed to buy the Waldorf Astoria in 2014, the US government opened an investigation into the sale (the US ambassador to the United Nations has a residence in the building and the President has stayed in the hotel in the past).[12] In 2006, Dubai Ports World faced US Congressional inquiries into its purchase of a number of US ports, which it eventually sold off to US buyers after a House of Representatives panel voted to block the sale. Reaching back to the 1980s and 90s, one of the catalysts for the FIRPTA rules discussed above may have been the increase in Japanese and other foreign investors in US real estate.

Beyond tax and regulations, foreign investors face more sophisticated and focused competition, quicker due diligence periods and a maze of local rules and regulations that can make the US markets more difficult to operate in than in some other countries. Closing large and complicated deals in a matter of weeks can be difficult for local teams and may prove even more difficult for those in other parts of the world with limited expertise on the ground.

12 Reuters, *US reviews Waldorf Astoria sale to Chinese firm*, October 14, 2014.

Conclusion

Foreign buyers are certainly investing in the US in volumes never seen before, looking for the perceived safety and relative strength of trophy assets in the largest US gateway cities relative to other parts of the world. However, a variety of factors – from US taxes and regulation to strong barriers to entry and steep competition – may be restraining international capital flows to the US. Should long proposed regulatory and tax reforms come to fruition and international capital sources continue to build local relationships and teams on the ground in the US, this may only be the beginning of a wave of foreign capital chasing commercial real estate deals in the gateway cities and beyond.

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Growing concerns over cybersecurity in the real estate sector

by Scott Williamson and Amandeep Lamba

Overview

As cybercrime runs rampant, reports of major cyber incidents and data breaches that would have been unimaginable just a few years ago pour from today's headlines, affecting organizations in every industry. The real estate industry has not historically been targeted like other industries; however, it is no longer the case. Real estate is a market steeped in heavy reliance on trust: owners, managers, tenants and investors. Malicious actors have proven that a breakdown in trust in any of these specific areas can cause damage to a real estate organization's reputation, brand or valuation.[1] Recently, real estate investment trusts (REITs) have become new targets for hacktivists, organized crime and potentially even nation states with their targeted acquisitions on US assets. Additionally, the responsibility to maintain secure access to physical assets and the systems operating those assets is equally important. A single compromise in trust can affect multiple organizations beyond the effects of typical breaches.

1 Erika Morphy, "Hackers May See Gold in Multifamily REITs' Systems," GlobeSt.com, October 2, 2014.

The threat environment

According to the Global State of Information Security Survey® (GSISS) for 2015, "more than 9,700 security professionals and business executives found that the total number of security incidents detected by respondents climbed to 42.8 million this year, an increase of 48% over 2013. Globally, the annual estimated reported average financial loss attributed to cybersecurity incidents was $2.7 million, a jump of 34% over 2013."

Cyberattacks are impairing businesses. In today's ecosystem, real estate organizations are generally dependent on technology and connectivity. This amplifies the business impact of cyberattacks, affecting intellectual property, competitive advantage, operational stability, regulatory compliance and reputation. For example, in September 2014, Essex Property Trust, a California-based real estate investment trust that owns and operates multifamily properties on the West Coast, reported that its computer networks, containing personal and proprietary information, were compromised by a cyber intrusion. In other cases, executives of major real estate organizations have been targeted for gaining access to sensitive confidential information related to deals, valuations and contracts. Additionally, several organizations have been targeted for social engineering scams resulting in disbursements of large amounts to fictitious accounts.

Cyberattacks can result in big wins for the malicious actors and can cause irreparable harm and significantly impact the targeted organization. The cost of such breaches vary by organization, which are derived based on the length of time the access is maintained, the access level achieved and the information exposed. Beyond the immediate cost of responding to the breach, there is also a longer-term impact. It may take months or years before the business feels the full effect on competitive advantage or degradation of cash flows. A recent study of 133 global institutional investors shows that 79% of them would be "discouraged" from investing in a business that had been hacked by cyber criminals.

Adversaries — motives, means and methods

Nation states, organized crime, hacktivists, terrorists and even employees are all potential adversaries. These adversaries are sophisticated, determined and patient, and they will target individuals, companies or industries to gain advantage. Their motives range from economic espionage, to rapid monetization of information, to advancing political agendas. Numerous attack groups are backed by seemingly limitless resources, and in some cases, are funded or informed by foreign intelligence services.

Adversaries use a wide array of methods and tactics to gain and maintain access while going undetected. Often the attack begins simply with an e-mail that contains an attachment or a link to a web site that compromises the victim's computer—and ultimately the core business. This type of attack leveraging social engineering is called phishing and is one of the top three types of attacks executed against organizations.[2] Once an employee within the organization is phished, the password is compromised, and the attacker effectively becomes a malicious insider. What makes phishing even more damaging is that 33% of Fortune 500 executives are taking the bait.[3] Phishing attacks are becoming increasingly common and successful, which provides malicious actors easy access to personally identifiable information (PII), proprietary information and unauthorized access to systems. Hospitality, multi-family and other real estate organizations store and maintain significant amounts of sensitive information in the form of PII or critical company information. Attackers are specifically looking to target PII: including credit card numbers, social security numbers, date of birth, bank account information, credit and debit card numbers, etc., all of which have a significant value in the black market.

Another emerging threat, particularly to REITs responsible for physical and information security, is exploiting the increased vulnerabilities of Industrial Control Systems (ICS). The number of attacks on supervisory control and data acquisition (SCADA) networks is increasing exponentially. In fact, a recent Dell Security Annual Threat Brief Report detailed that worldwide SCADA attacks increased from 92,000 in 2013, to more than 163,000 in 2014. Furthermore, although the "Internet of Things" is still in its infancy, the security industry is expected to be one of the most common industries impacted as customers (and renters) adopt technology that gives them centralized and remote control over a myriad of devices. The real estate industry is heavily reliant on ICS technology to drive down costs of everything from HVAC systems to reducing the need for physical security by reliance on security cameras and remote monitoring. The exposure is greater for "smart" buildings, specifically for trophy assets, that are heavily wired for automation, remote monitoring and management capabilities. Nefarious cyber actors are increasingly targeting the extensive vulnerabilities associated with ICS and SCADA networks.

2 GSISS 2014.

3 Joe Ferrara, "Phishing Attacks Explode and Executives Are Taking the Bait," *SC Magazine*, August 7, 2013.

Increasing your cyber resilience

Cyber risk reduction for real estate organizations should be based on a comprehensive security strategy. The implementation of a well-defined strategy that identifies the critical data the organization holds, where the data resides and who has access to it, helps build an effective cyber risk management plan. Such a plan examines the current state of the organization and establishes a roadmap to design and operate a robust security program that includes the right balance of measures allowing organizations to better plan, prevent, detect and respond to cyber-attacks. Below are six leading aspects to combat and minimize cybersecurity risks:

- **Own the risk:** Cyber risk must be owned by leadership and not relegated to the IT function. The foundation of a cyber resilient organization is an effective governance framework that is built into the larger enterprise-wide risk management framework. An effective cyber risk governance framework should include appropriate governance, oversight and operations committees, each with clearly defined responsibilities, operating processes and reporting lines.
- **Enhance culture:** A security culture and mindset is imperative for driving improvements in an organization's cybersecurity strategy. Executive sponsorship, ownership and messaging can help drive the right behaviors, reinforce the importance of cyber risk management and the need for everyone to increase vigilance. The effectiveness of management's efforts on establishing the right mindset and education should be supported with tools and capabilities for measurement and reporting.
- **Prioritize initiatives:** Organizations should determine what comprises their most valuable revenue streams, business processes, assets and facilities. These are collectively referred to as "crown jewels." Once the crown jewels are identified and the cyber organization boundary is defined, organizations must assess the effectiveness and appropriateness of safeguards to protect the crown jewels and prioritize and monitor cybersecurity investments.
- **Secure the business:** Cybersecurity and privacy programs that implement the correct balance of strategy, technologies, processes and resources can enable the organization to achieve its goals while protecting the assets most critical to its competitive advantage, brand and shareholder value. Organizations should look to use one of the many available frameworks to assess, transform and implement an effective security program. The NIST Cybersecurity Framework is gaining momentum and the Administration has indicated there may be two big benefits to organization's that use the NIST framework: regulatory streamlining and cyber insurance.
- **Learn and incorporate:** Effective cyber risk monitoring focuses on building a sustainable and resilient approach to putting intelligence inputs from various teams under a common lens to quickly correlate threats in real time. Organizations should consider establishing or leveraging threat analysis capabilities built on intelligence, data and research from internal and external resources. Real estate organizations should consider joining, if they haven't already, one of the many Information Sharing and Analysis Centers (ISACs) that are industry focused.
- **Plan and respond:** The development of planned responses – cyber incident response playbooks – is a necessary step in adequately planning and preparing for cyber events. The playbooks should outline stakeholder involvement, their responsibilities, actions to take based on type of incident and communication and reporting requirements. Additionally, similar to a company's cyber perimeter and crown jewels, the incident response playbooks must be updated as needed based on changes in operations and the evolving cyber threat landscape.

PwC recently created a digital game – "Game of Threats" – that is gaining popularity amongst Boards and Executives for real-world cybersecurity planning and response awareness and training. Within the context of a competitive environment (threat actors vs. company), the Game of Threats offers players an innovative way to simulate the critical decisions that executives must make in the midst of a cyber breach. The interactive experience is realistic – challenges participants to make quick, high impact decisions with minimal information. Players walk away with a better understanding of the steps (e.g., technical, cybersecurity, governance, etc.) they wish to take to better secure their companies going forward.

Summary

The real estate market is a new, visible and attractive target for cyber-criminals. Leaders within the industry should not ignore the risks their organizations face, as well as the need for a strategy and plan to address the ever evolving cybersecurity risks. Real estate organizations should adopt a comprehensive approach to address these risks, including:

- Building an effective cyber risk governance framework with executive sponsorship and support;
- Establishing an enterprise-wide strategy and approach to cybersecurity that goes beyond IT and includes key tenants of planning, preventing, detecting and responding to a cyber-attack; and,
- Monitoring the implementation and effectiveness of organizations' cybersecurity posture through a combination of strategic and technical assessments focused at the enterprise and business unit level, as well as other third parties that are part of the overall ecosystem.

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Investors monitor growing levels of new construction

by Susan Smith

The following is extracted from the Second Quarter 2015 issue of the PwC Real Estate Investor Survey, released on June 15, 2015. The findings and opinions reflect those of the investors surveyed and do not necessarily reflect the views of PwC.

Presently, new construction completions remain in check for most property sectors in the commercial real estate (CRE) industry with the possible exception of apartments, but as more announcements of new projects are made, the rise of construction activity, ground breakings and announced projects has some investors starting to feel a bit nervous. As one Survey participant comments, "Additions to supply have been pretty disciplined over the past years, but we are now seeing more cranes dot the horizons in various cities." Increased construction activity tends to happen nearly every time at this point in the CRE recovery – at the point when most property types and metros are moving into either the recovery or expansion phase of the real estate cycle. As a result, most surveyed investors are monitoring construction levels across property sectors, as well as geographies, in order to adjust investment strategies if necessary.

In the apartment sector, many Survey investors are keeping a close eye on rising levels of new completions, especially for 2015 when a significant number of units are expected to be delivered. Completion estimates for 2015 make it the highest annual amount for this sector in five years, a level unseen since the 1980s. In anticipation of new supply, some investors are fine-tuning their strategies and underwriting practices by holding apartment assets to see how additions to supply play out. Others are not buying new assets in markets with significant levels of new construction. One surveyed investor notes, "Our purchases are much more selective now due to the high level of new construction occurring."

New construction activity in the office sector is where some of the deepest concerns lie among surveyed investors as the pace of office construction has really picked up. In many major cities, new supply is either underway or expected to break ground soon. Survey respondents noted that while some of these new developments are build-to-suit projects, most of them are speculative. Even though some preleasing is occurring, certain investors believe that tenants are merely "shuffling" from tower to tower and that "real" tenant expansions and in-migrations account for a small portion of preleasing.

Cities with significant amounts of new office space construction underway include Dallas, San Francisco, Phoenix and Chicago – where many trends currently lean in favor of property owners. The hope is that these positive trends continue to occur during the development cycle and that the new office properties are delivered in time to allow owners to capitalize on mounting leasing demand and rising rental rates.

Overall cap rates

In the second quarter of 2015, the average overall capitalization (cap) rate decreased in 26 Survey markets, held steady in four and increased in four. The declines are diverse and spread across property sectors and locations with the national regional mall, national flex/R&D market and the city-specific office market of Suburban Maryland posting the steepest drops this quarter. In contrast, average overall cap rates held steady for the Pacific and Mid-Atlantic region apartment markets, as well as the city-specific office markets of San Francisco and Washington, DC.

Our Survey results show that average overall cap rate expansion is the greatest for both the Manhattan and Houston office markets, where cutbacks in the US energy sector and additions to supply are negatively impacting fundamentals. In contrast, the average expanded just one basis point in Dallas and Chicago this quarter.

National student housing market

The national student housing market debuted in the Survey in the second quarter of 2014. As investors look to diversify, investing in student housing properties is becoming more mainstream than it was many years ago as the sector's solid performance over time continues to draw investors, attracting a large and diverse pool of buyers. In the first quarter of 2015, total student housing transactions rose considerably over the prior year. In addition, capital sources changed between 2014 and year-to-date 2015 to include a larger percentage of institutional funds compared to private money.

Due to rising tuition costs and declines in enrollment at many universities, some student housing investors are adjusting their investment strategies by focusing on properties near colleges and universities that offer "good return on investment for students." While many investors are strictly purchasing assets, others believe conditions warrant holding and/or building student housing properties.

CRE sector overviews

Office

The national CBD office market continues to strengthen as leasing trends accelerate in most major downtown cores. As the office sector's recovery gains momentum, the pace of new construction is expected to accelerate. However, many Survey participants are not overly concerned about a major disruption to underlying fundamentals. As a whole, the near-term outlook for the national CBD office market remains quite favorable with certain participants expecting property values to increase significantly over the next 12 months.

As many suburban office locations mirror their improving downtown counterparts and post positive gains in absorption and rent growth, many investors are ramping up acquisitions of suburban office assets. According to surveyed investors, some of the best-performing suburban office markets are San Francisco, San Jose, East Bay, Chicago, Denver and Los Angeles.

Retail

Strong economic growth and steady employment gains are helping to increase consumer traffic and spending at many regional malls, improving retail sales per square foot. At the same time, positive trends are enabling many mall owners to raise rental rates and dictate lease terms.

In the national power center market, empty big-box stores and limited re-leasing options remain challenges for many investors when reviewing both offerings and owned assets. Certain property owners note that some health care providers have been settling into empty big-box spaces while other larger units have been split in order to "re-lease to junior anchor tenants with better credit profiles."

Overall, limited additions to supply and a recovering U.S economy should continue to bode well for the national retail sector over the near term. Our PwC real estate barometer shows the number of markets in the recession phase of the real estate cycle continuing to shrink over the next four years. Retail metros in the recovery phase of the cycle by year-end 2015 are expected to include Philadelphia, Tampa and Portland while Buffalo, Fort Worth and San Antonio are expected to be in the expansion phase.

Industrial

Shifts in this quarter's key indicators continue to paint a favorable outlook for the national warehouse market. When looking to acquire warehouse assets, certain Survey investors prefer those located near ports, while others are focusing on secondary cities because of less competition among buyers. "We like Charlotte and San Antonio for warehouse ownership," says a Survey participant. Other locations noted as offering some of the "best opportunities" for warehouse investing include Los Angeles, Seattle, Southeast Florida and "anywhere in Texas."

In the national flex/R&D market, the average overall cap rate remains on a downward trend, suggesting that Survey investors see fundamentals continuing to improve in the near term. Even though supply-demand fundamentals lean in favor of owners, surveyed investors have yet to increase initial year rent growth expectations. However, some predict that future rent increases are inevitable as occupancy gains outpace additions to supply. In fact, certain investors are incorporating rent spikes in their cash flow analyses.

Apartment

As a result of rising levels of new supply, the national apartment sector is projected to continue its transition from the expansion phase of the real estate cycle to the contraction phase during 2015, as per our PwC real estate barometer. In addition, surveyed investors unanimously foresee overall cap rates holding steady amid continued additions to apartment stock over the next six months.

Similar to the national apartment market, investors seeking assets in the Mid-Atlantic, Pacific and Southeast apartment regions are keeping an eye on supply trends and their impact on underwriting criteria. Overall, the outlook for future rent growth is minimal even though many investors believe property values will increase in these three apartment regions in the coming year.

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.

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Real estate state and local taxation: Industry update

by Sean R. Kanousis, Jong Taek Ban and Colin M. Coogan

New York City tax reform

On April 1, 2015, the New York State legislature passed a bill to overhaul New York City's corporate tax regime and to substantially conform New York City tax law to the changes enacted through New York State tax reform in 2014.[1] The legislation was signed into law on April 13, 2015 and is effective for tax years beginning on or after January 1, 2015, which is the same effective date as the New York State legislation.[2]

In contrast with the New York State reform legislation, the New York City legislation did not enact an economic nexus standard for corporations or corporate partners. A corporation is generally only taxable in New York City to the extent it, or a partnership in which it holds an interest, has a physical presence in New York City.[3] Additionally, the New York City legislation does not phase out the capital base tax. The capital base tax rate is 0.15 percent and the maximum capital base tax will be raised to $10 million.[4]

Otherwise, the New York City legislation substantially conforms to the New York State reform legislation. The legislation adopts the combined filing requirements that were enacted as part of New York State reform and eliminates the substantial intercorporate transactions test. Two or more corporations engaged in unitary business will be required to file a combined report if one corporation owns or controls, either directly or indirectly, more than 50 percent of the voting power of the capital stock of the other corporation or if more than 50 percent of the voting power of the capital stock of each corporation is owned or controlled, directly or indirectly, by the same interests.[5] Non-captive REITs are statutorily exempt from combined reporting. [6] Additionally, corporations incorporated outside of

1 NYS FY 2015-2016 Freestanding Article VII bill containing various provisions of law related to the 2015-2016 Executive Budget (S4610-A/A6721-A).

2 Id., NYC Administrative Code § 11-651.

3 NYC Administrative Code § 11-653(1)(A), (F).

4 NYC Administrative Code § 11-654(1)(e)(1)(ii).

5 NYC Administrative Code § 11-654.3(2)(a).

6 Id. at (2)(c).

the United States that are either treated as domestic corporations for federal income tax purposes or which have income effectively connected with a US trade or business as determined under IRC section 882, may be included in a combined report if they meet the stock ownership and unitary tests.[7]

Non-captive REITs and captive REITs that file on a separate basis will continue to owe the greatest amount of tax calculated under the business income method and the fixed dollar minimum method.[8] New York City continues to permit the dividends paid deduction for a REIT filing a separate return, which will reduce the REITs business income so that the REIT will generally pay the fixed dollar minimum tax.[9] The business income tax is based on entire net income minus investment income and other exempt income.[10] The tax rate on business income is 8.85 percent for most corporations.[11] The fixed dollar minimum tax is based on New York City receipts. The maximum fixed dollar minimum tax is $200,000 if the taxpayer has New York City receipts of over $1 billion.[12]

Captive REITs that are included in combined reports are subject to the highest of three taxes (the business income base tax, the capital base tax and the fixed dollar minimum tax of the designated agent), plus the amount of fixed dollar minimum tax for each member of the combined group, other than the designated agent, that is a taxpayer.[13] In computing the tax bases for a combined report, the combined group is generally treated as a single corporation.[14] The capital base tax would therefore include the total combined capital of all members of the combined report allocable to New York City, including the capital attributable to the captive REIT. The capital base is computed on the combined group's total combined assets less its total combined liabilities, allocable to New York.[15] This effectively means that a captive REIT included in a combined report can become subject to the capital tax.

S Corporations have historically been subject to the New York City's corporate income tax. While S Corporations will remain subject to the corporate income tax, they have been effectively carved out of the current legislation. Instead of applying the new provisions, S Corporations will be required to determine their tax under New York City's previous corporate income tax regime. Also, the legislation does not modify the provisions of New York City's Unincorporated Business Tax.

City taxpayers should review their investment structures to determine the impact of the legislation. The removal of the substantial intercorporate transaction requirement increases the likelihood that a captive REIT may be required to file a combined report and lose its dividends paid deduction. Previously, a substantial intercorporate transaction existed if 50 percent or more of corporation's receipts or expenditures are from one or more related corporations.[16] Going forward, a captive REIT need only share a unitary relationship with a taxable REIT subsidiary to be forced into a combined report. The carve out of S Corporations from the legislation is also notable. S Corporations will not be able to apply New York City's recently adopted market sourcing provisions when determining their corporate income tax. Accordingly, S Corporations will be required to apply different apportionment rules for City and State purposes. For example, S Corporations will not be able to apply the State's recently enacted customer based sourcing regime for sourcing revenue received from the performance of services. Instead, the service revenue will be sourced based upon the location of where the services were performed unless the taxpayer is a registered securities or commodities broker or dealer then customer sourcing rules may apply.

7 Id.

8 NYC Administrative Code § 11-653(7).

9 NYC Administrative Code § 11-653(7).

10 NYC Administrative Code § 11-652(7).

11 NYC Administrative Code § 11-654(1)(E). Lower rates may be available depending on the amount of a corporation's business income before or after allocation to NYC. Id.

12 NYC Administrative Code § 11-654(e)(1)(iv).

13 NYC Administrative Code § 11-654.3(1)(a).

14 Id. at (1)(b).

15 Id.

16 New York Advisory Opinion, TSB-M-08(2)C (March 3, 2008).

Nevada Commerce Tax

Nevada recently enacted a Commerce Tax which is effective July 1, 2015.[17] The Commerce Tax is an annual tax imposed on each business entity engaged in business in Nevada. A business entity, for purposes of the tax, is defined to include "a corporation, partnership, proprietorship, limited-liability company, business association, joint venture, limited-liability partnership, business trust, professional association, joint stock company, holding company and any other person engaged in a business."[18] REITs are generally excluded from this definition, however, a REIT that holds assets directly, rather than through limited partnerships or other entities, is treated as a business entity subject to the tax.[19] A limited partnership that directly holds real estate is also a business entity subject to the tax regardless of whether a REIT holds an interest in the limited partnership.[20]

The tax is based on gross revenue apportioned to Nevada with a $4,000,000 standard deduction.[21] There is no deduction for cost of goods sold or other expenses incurred, however, deductions are permitted for interest income (other than interest on credit sales); dividends and distributions from corporations; distributive or proportionate shares of receipts and income from a pass-through entity; and receipts from the sale, exchange or other disposition of an IRC section 1221 or 1231 asset regardless of the holding period.[22] There is also an exclusion from gross revenue for amounts realized from a transaction subject to, described in, or equivalent to, IRC sections: 118, 331, 332, 336, 337, 338, 351, 355, 368, 721, 731, 1031 or 1033, regardless of the federal tax classification of the business entity. The Commerce tax rate varies from 0.015% to 0.331%, depending on the industry. The real estate and rental and leasing industry tax rate is 0.250%.[23] The construction industry tax rate is .083%, the hotel industry tax rate is 0.2%, and the gaming industry tax rate is 0.24%.[24]

The tax is imposed on a separate entity basis, however, deductions may be available for income received from other members of an affiliated group or from passive entities. Income received from another affiliated group member is deductible.[25] A group of two or more business entities directly or indirectly controlled (50% or more ownership) by one or more common owners constitute an affiliated group.[26] Similarly, income received from a passive entity, if not otherwise deductible as distributive share income received from a pass-through entity, may be deductible.[27] A passive entity satisfies the following requirements: (1) the entity is a limited-liability company, general partnership, limited-liability partnership, limited partnership or limited liability limited partnership, or a trust, other than a business trust; (2) at least 90 percent of the entity's federal gross income consists of qualified income, including dividends, interest, capital gains from the sale of real property and gains from the sale of certain commodities and securities, but NOT including rent; and (3) the business entity does not receive more than 10 percent of its federal gross income from conducting an active trade or business.[28] Passive entities are not included in the definition of a business entity and are not subject to the tax.

The reporting period for all taxpayers is July 1 to June 30, and the first report is due 45 days after the end of the fiscal year ending June 30, 2016. Taxpayers may request a 30-day extension.[29]

Hawaii dividends paid deduction update

The Hawaii legislature introduced a bill in January of 2015 that would amend Hawaii law to eliminate the deduction for dividends paid, as permitted under section 857(b)(2)(B) of the Internal Revenue Code.[30] However, the bill was subsequently amended to remove this language. Rather than eliminating the dividends paid deduction, the final version of the bill directs the Hawaii Department of Business, Economic

17 Revises provisions related to governmental fiscal administration, Sec. 20, S.B. 483, 78th Sess., Nevada Assembly (2015) ("Nevada S.B. 483").

18 Nevada S.B. 483, Sec. 4(1).

19 Id. at (2)(i)(1).

20 Id. at (2)(i)(2).

21 Nevada S.B. 483, Sec. 20.

22 Nevada S.B. 483, Sec. 21.

23 Nevada S.B. 483, Sec. 38.

24 Nevada S.B. 483, Sec 27, Sec. 46 and Sec. 45.

25 Nevada S.B. 483, Sec. 21.

26 Nevada S.B. 483, Sec. 11(2)(a).

27 Nevada S.B. 483, Sec. 21(1)(aa).

28 Nevada S.B. 483, Sec. 14.

29 Nevada S.B. 483, Sec. 20.

30 Relating to Real Estate Investment Trusts, S.B. 118, 28th Legis., Hawaii Senate (2015). Hawaii currently conforms to the federal dividends paid deduction. See Hawaii Rev. Stat. § 235-2.3(b).

Development and Tourism to study how repealing the dividends paid deduction would affect Real Estate Investment Trusts in Hawaii. This final version of the bill was enrolled to Governor David Y. Ige on May 8, 2015 but the Governor has not taken any action regarding the enactment of this bill into law at this time.

California Prop 13 update

A bill in the California state legislature has been introduced that would modify California Proposition 13 by amending the California Constitution allowing for commercial and industrial properties to be assessed at full market value for property tax purposes. This "split-roll" would not impact residential or agricultural properties. The bill needs to be approved by a two-thirds majority in the State Legislature in order to be placed on the ballot to be decided by the state's voters. The bill would have far reaching effect on the real estate community and should be monitored closely. Currently the assessed value of California real property can only be increased by 2% each year except in cases of changes of ownership or completion of new construction.

Connecticut combined reporting update

On June 30, 2015 Connecticut governor Dannel Malloy signed House Bill 7061 into law implementing a combined reporting regime in Connecticut for all tax years beginning on or after January 1, 2015. The combined reporting regime replaces Connecticut's prior tax regime which required taxpayers to file on a separate company basis unless an election was made by the taxpayer to file on either a consolidated or combined basis.[31, 32] A combined group will comprise all companies that meet the common ownership and unitary business requirements provided that at least one of those companies is subject to taxation in Connecticut.[33] The group will be determined on a water's-edge basis unless the combined group makes an election to file on a world-wide or affiliate group basis.[34] Corporations included in a water's edge basis include: US corporations if 80% of more of its payroll and property are located outside the United States, foreign corporations if 20% or more of both its payroll and property are located in the United States and foreign corporations incorporated in certain tax havens. The combined group calculates its net income by aggregating each taxable members' Connecticut net income as calculated on a separate basis and any dividends paid by one member to another of the combined group must be eliminated. The state's captive REIT provisions were not modified as part of the legislation.[35, 36]

31 Conn. Gen. Stat. § 12-223a(a)(amended in 2015).

32 Conn. Gen. Stat. § 12-218d(amended in 2015).

33 Conn. Gen. Stat. § 12-213(a)(29)(added in 2015).

34 Conn. Gen. Stat. § 12-222(g)(added in 2015).

35 H.B. 7061, § 140, 2015 General Session (Ct. 2015).

36 H.B. 7061 creates some new sections of law rather than amending sections of law that existed under prior law. Such new sections have not been assigned legal citations under the Connecticut General Statutes yet. As such, we cited to the relevant section of H.B. 7061 instead.

Connecticut taxpayers should review their investment structures to determine their Connecticut filing requirements moving forward. The legislature may impact the tax filing requirements of REITs going forward as REIT's may now be required to file combined reports with taxable REIT subsidiaries or other related corporations. Previously, REITs were not eligible to be included in elective combined or consolidated returns.[37]

37 Connecticut Informational Publication No. 2010(21), 12/01/2010.

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