Current developments for the real estate industry

Summer 2018

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The new leases standard is effective for calendar year-end public business entities (PBEs) on January 1, 2019. The FASB has issued and proposed several practical expedients to help companies apply the new standard, all of which are discussed in further detail below.

Leasing changes for lessors

The new leases standard requires a lessor to separate lease components from nonlease components in a contract. The lease components should be accounted for in accordance with the new leases guidance, and the nonlease components should be accounted for under other applicable guidance (e.g., revenue guidance). However, in March 2018, the FASB tentatively approved a new practical expedient, which may change how lessors account for contracts with both lease and nonlease components. If approved as proposed, lessors will have the option to aggregate the nonlease components with the associated lease component of a contract if the following conditions are met:

- The timing and pattern of transfer for the nonlease component and the associated lease component are the same
- The lease component would be classified as an operating lease on a stand-alone basis

If a lessor elects this practical expedient, it would account for the combined component based on its predominant characteristic. If the nonlease component is predominant, a lessor would account for the combined component as revenue. However, the lessor would account for it as an operating lease if the lease component is predominant. This practical expedient is required to be elected by class of underlying asset. Further, if elected, the expedient will need to be applied consistently to all components that meet the stated criteria.

The new practical expedient should make the application of the new leases standard easier and more cost effective for many lessors. For example, lessors with eligible operating real estate leases that also provide maintenance services could elect to not separate the nonlease maintenance services component from the real estate lease component. These components would otherwise need to be separated based on their standalone selling prices. Lessors will need to apply judgment to determine the predominant characteristic of the combined component when applying this practical expedient.

Further, the FASB tentatively agreed to another practical expedient that will allow lessors to make accounting policy elections to exclude sales taxes, property taxes, and insurance from contract consideration when those costs are paid directly by the lessee and the amount to be paid is uncertain. This is a change from the new leases guidance, as currently written, which would require lessors to quantify these lessor costs and report them gross as revenue and expense in the income statement.

The proposed improvements to the presentation of certain lessor costs will be exposed for public comment. For more information on these proposed changes, please read In brief, The new leases standard made easier for lessors.

Other practical expedients to consider when implementing the new leases guidance

In addition to the lessor practical expedients discussed above, there are a number of transition-related practical expedients for lessees and lessors to consider when adopting the standard, including the "package" of practical expedients. The "package" refers to the following three expedients that must be adopted together:

- A company does not have to reassess whether an arrangement contains a lease
- A company can carry forward its lease classification as operating or capital leases
- A company does not have to reassess its previously recorded initial direct costs

For additional insights, see our video on the "package" of practical expedients:

Other practical expedients permit lessees and lessors to elect to:

- Apply the new leases guidance at its effective date without adjusting the comparative financial statements,
- Use hindsight to determine the lease term and to assess any impairment of right-of-use assets during the lookback period, and
- Continue their historical accounting for land easements, but only if they were not previously accounted for as leases.

For more information, watch our video on these other leasing practical expedients:

In addition, for more information on the new leases standard, please refer to In depth, Assessing land easements under the leases standard, and PwC's CFOdirect Podcast series, Episode 33: Leasing - recent proposals, impairment and subleases. Also, see our video library on CFOdirect.com for guidance on adopting the new leases standard, including our recent videos on embedded leases, lease term and the incremental borrowing rate.

II. In the market and recent real estate trends

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1. *Zones of Opportunity or Zones of Uncertainty*

PwC's US Real Estate Leader, Byron Carlock, recently published a Blog which may be of interest to you and your company. The blog discusses Opportunity Zones and Driving Investments through Tax Innovation. Refer below to read more about his recent insights on the topic.

Shared value is a principal that is becoming more and more prevalent in society. What is shared value? It is a concept created by Harvard Business School professor Michael Porter. It is the idea that economic prosperity and social progression can be achieved simultaneously. That all stakeholders, investors and the public can benefit from business.

The idea of shared value has been further promulgated by Larry Fink, chairman and CEO of Blackrock. In his annual letter to CEO's, he says that "... to prosper over time, we must not only deliver financial performance, but also show how it makes a positive contribution to society". He emphasizes the importance of social responsibility, e.g. generating economic value in a way that also produces value for society. Both of these ideas have become more prevalent in the American lexicon, flowing seamlessly throughout both business and politics.

The concept of shared value should be embraced by managers and investors alike, given current personal household wealth trends. The wealth gap in this country is continually growing. The top 1% control more of the country's wealth now, than they did 50 years ago. While at the same time, 1 out of 6 Americans live in "Distressed communities", where the median household income is below $60,000. According to the U.S Census Bureau, the median income in the United States remained essentially unchanged for the third year. Furthermore, many speculate that the continuing lack of financial security of the middle class has led to birthrate crisis, with the United States at a 30 year low, a sign of demographic frailty. Many parts of the country have still not recovered from the 2008 recession, with residents, businesses and investors alike fleeing towards places with more opportunities, more chances for benefiting from shared value and their chance to prosper. While the landscape for middle-income Americans may appear to have stagnated change on the horizon; there is a provision within the new tax legislation that could bring hope – and drive investment in the towns and communities who need it most.

The 'Tax Cuts and Jobs Act' (Subchapter Z), aims to create shared value through tax incentives, via the concept of 'Opportunity Zones'.

Opportunity Zones: Driving Investment Through Tax Innovation

Opportunity Zones will use tax incentives to draw long-term investments to parts of America that continue to struggle economically. In its most basic form, the provision allows for a gubernatorial nomination of areas within their jurisdictions to be 'Opportunity Zones'. If an individual or corporate taxpayer sells property (stock and assets), all gains on the sale can be tax free or deferred by reinvesting the proceeds, equal to the gain, into an Opportunity Zones.

An investor who retains an investment, in the Opportunity Zone, for seven years will pay only 85% of the capital gains tax originally due. Furthermore, 100% of the proceeds from the Opportunity Zone investments, if held for over 10 years, are free from capital gains tax.

Opportunity Zones also have the potential to become great examples of philanthropic infrastructure. Using the

Rose Kennedy gardens in Boston, as a template, a tourist attraction and an urban refuge for locals, the private public venture that has stimulated the local economy. Attendance increasing sevenfold since 2009, hundreds of thousands of visitors attend the park yearly.

Does the return outweigh the risk?

The benefits of this program could be immeasurable, including (1) bringing life back to the distressed areas nominated; (2) spurring job growth and creation; (3) growing small businesses; (4) promoting gentrification and diversification of business, residents and development; and (5) delivering consistent investor returns.

However, like all initiatives, Opportunity Zones are prone to many challenges. One of the biggest is ensuring that the proper areas are designated. As it is gubernatorial nomination, the governor's office bears the responsibility of selecting the distressed areas to be Opportunity Zones. (If interested to know what areas are/aren't eligible, view this opportunity eligibility tool created as part of the TCJA). Nominating areas that have deals already in the pipeline is simply a waste of investor capital, time and due diligence. Furthermore, Opportunity Zones require a timely investment. In order to reap the full benefits of the tax incentives, investments must be held for at least 10 years. This has left many concerned that opportunity funds will take a year or two to catch on. How the above factors are addressed, will determine the success of the Opportunity Zones.

No one knows how this tax provision will pan out; however, I like to think that slow progress is better than no progress -- and that progress is impossible without change. Opportunity Zones are offering change to communities that haven't seen change since the great recession.

I'm hopeful that Opportunity Zones can serve as the catalyst for development and redevelopment in communities that feel forgotten and left behind. Implemented correctly, we can achieve shared value on a national scale while delivering social responsibility.

After all, I'm a "glass half full" kind of guy.

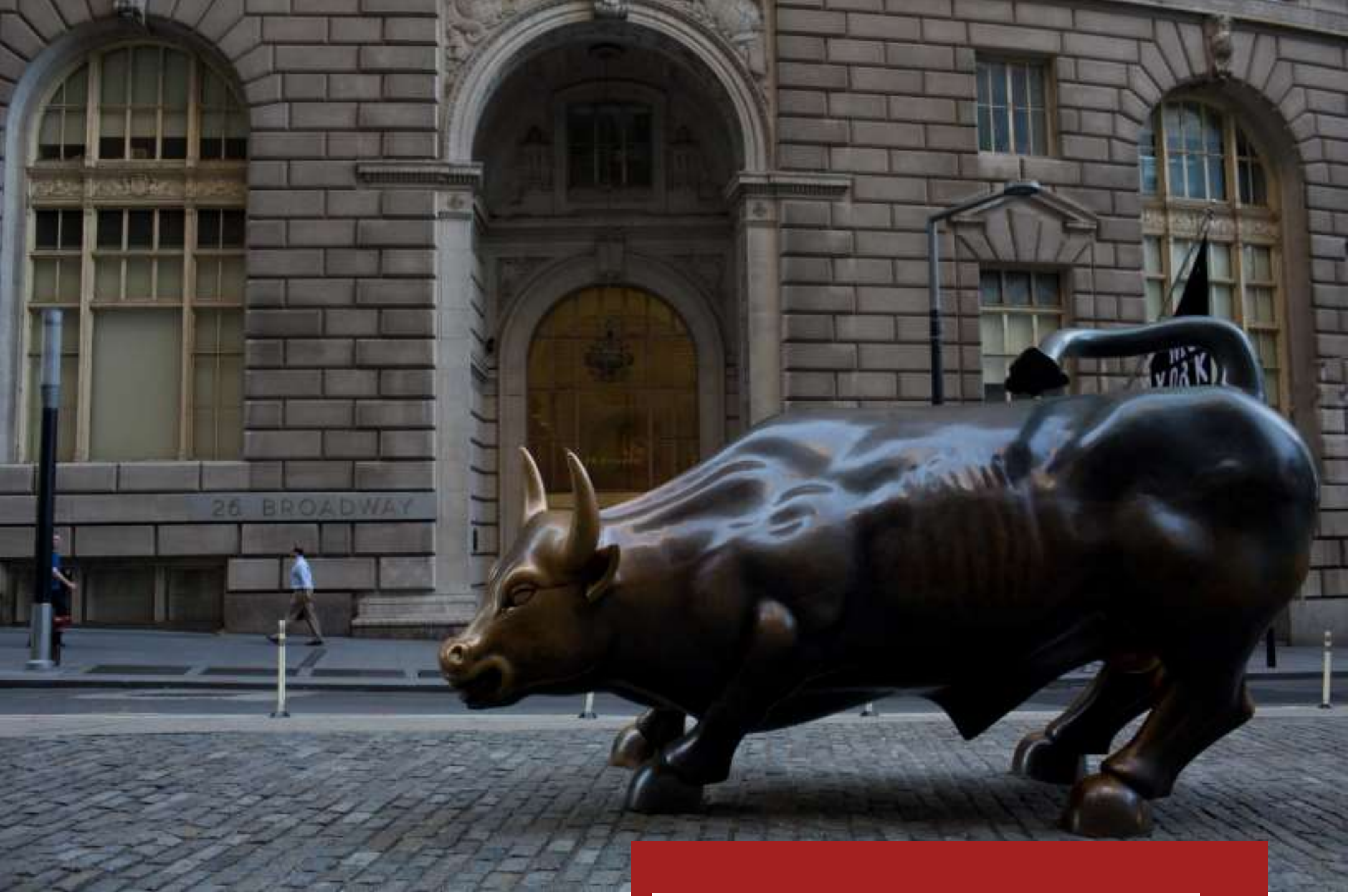
I'd love to hear your thoughts about this proposal, too.

2. *PwC Deals: A look back at US Real Estate Deals Insights from Q1 2018*

The first quarter of 2018 was characterized by stability in operating fundamentals, cap rates and overall transaction volume. However, we have observed shifts in the market participants driving this activity, with foreign institutional investors and business from adjacent industries driving a greater proportion of current period activity. This creates a dynamic deals environment where the depth of a firm's relationships, scale, execution efficiency and people matter to the achievement of successful deal outcomes.

Moreover, we have observed substantive impacts on real estate activity due to the impact of the megatrends – particularly shifting demographics, urbanization and technology. These impacts are contributing to a unique real estate environment, elongated cycle and an overall positive outlook on the deals environment moving forward. It will be important to keep a careful eye on those market participants – particularly those from the technology sector both domestically and internationally.

To learn more about trends, highlights, and deal activity in the real estate sector from Q1 2018, please refer to the recent PwC Deals publication Q1 2018.



III. Accounting and financial reporting hot topics

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1. Recognition and measurement disclosures: Interpreting the FASB's new guidance

The FASB's new recognition and measurement guidance is effective for calendar year-end public business entities in the first quarter of 2018. PwC has received several inquiries regarding the new disclosures required by the amendments to ASC 321, *Investments - equity securities*. PwC has prepared an In depth, A look at current financial reporting issues which includes our interpretive guidance to assist reporting entities as they prepare their initial disclosures under the revised guidance.

ASU 2016-01 impacts the accounting for equity investments, financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments, among other topics. Refer to the In depth, A look at current financial reporting issues for additional information on the FASB's new recognition and measurement guidance.

2. Deeply discounted debt and the statement of cash flows

The new cash flows guidance prescribes a specific presentation for payments of deeply discounted debt, which is debt with either a zero coupon interest rate or a coupon interest rate that is insignificant in relation to the borrowing's effective interest rate. Under the new guidance, cash payments for the settlement of deeply discounted debt should be split between two classifications on the statement of cash flows:

- The portion attributable to accreted interest related to the debt discount should be classified as an operating cash outflow
- The portion attributable to proceeds received at issuance should be classified as a financing cash outflow

For example, if a zero coupon bond with a par value of $100 is issued for $90, when the $100 is repaid at settlement, the $10 of accreted interest would be presented as an operating cash outflow and the repayment of the $90 received at issuance would be presented as a financing cash outflow.

Questions have arisen as to whether certain instruments, specifically (1) cash convertible debt instruments and (2) debt instruments where the interest is required or permitted to be paid-in-kind (PIK notes), are in the scope of this guidance. Refer to PwC's The quarter close – Q2 2018 to learn more about the treatment of deeply discounted debt and the statement of cash flows under the new guidance.

3. Definition of a business - the screen test

To apply the screen test, a company should first identify whether it has acquired any assets that should be grouped as one or more "single assets." A single asset for purposes of the screen test may include assets that are classified separately for financial reporting because the screen test guidance requires that:

- A tangible asset that is attached to another tangible asset (or an intangible asset representing the right to use a tangible asset) should be considered a single asset. To be considered attached, assets cannot be physically removed and used separately without incurring significant costs, and
- In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets should be considered a single asset.

After identification of the single assets acquired, a company should consider if a single asset should be grouped with other similar assets based on their nature and risk characteristics. It will require judgment to determine if similar assets should be grouped. The guidance contains examples of this evaluation and includes specific assets that would not qualify as similar for purposes of the screen test (e.g., a financial asset and a nonfinancial asset). For example:

Background:

- A real estate company acquires ten residential homes (including the land, houses and property improvements) and the related in-place leases.
- The residential homes are located in the same neighborhood but are dissimilar in size and layout.
- The company does not acquire any employees or other assets.

Identifying a single asset

First, the company should identify the single assets acquired. The combined land, houses, property improvements and in-place leases at each of the ten properties would be a single asset because:

- The houses and property improvements are attached to the land and cannot be removed without significant cost, and
- The in-place leases cannot be separated from the real estate.

However, for financial reporting purposes, the in-place leases, land, houses and property improvements should be accounted for under the guidance applicable to each asset class and may be presented separately in the company's financial statements.

Identifying a single asset

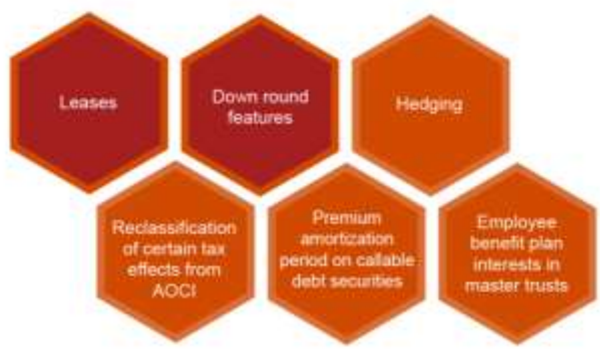
Next, the company would determine whether the ten single assets acquired should be grouped as similar assets to apply the screen test. After considering all relevant facts (e.g., class of customer, neighborhood, and type of property), the ten single assets would likely be considered similar assets for purposes of the screen test. Although the homes are different in size and layout, the nature of the assets (all residential homes) and the risks associated with operating the properties are similar since the class of customer, neighborhood and types of property are not significantly different.

For more information, please refer to In depth, The FASB's new definition of a business, In the loop, The new business definition: Why it matters and section 1.3 of our Business combinations and noncontrolling interests guide.

4. *Guidance effective in 2019 for calendar year-end PBEs*

Even as PBEs are absorbing the impacts of adopting new standards during 2018, they should be gearing up for the adoption of the new standards effective for calendar year-end PBEs in 2019. There are six new standards effective for calendar year-end PBEs on January 1, 2019.

The following graphic identifies the FASB guidance effective in 2019 for calendar year-end PBEs. In the section that follows the graphic, we highlight the new guidance related to down round features.



The FASB's active standard setting means it is more important than ever to know which standards are effective when. Please refer to the PwC CFOdirect page, *Effective dates for new FASB guidance*, where PwC has provided all of the FASB's recently released guidance separately for public companies and nonpublic companies

IV. Regulatory considerations

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1. It's not too early to start thinking about critical audit matters

Beginning in mid-2019 for audits of financial statements of large accelerated filers, auditors will be required to communicate critical audit matters (CAMs) in their audit reports. CAMs are any matters arising from the audit of the financial statements communicated, or required to be communicated, to the audit committee and that (1) relate to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.

Management and audit committees may be interested in engaging with auditors on CAM reporting requirements in advance of the effective date. We have provided an illustrative road map to help accomplish that goal.

For more information, refer to our Point of view, Auditor reporting: Changes coming and, In depth, SEC approves PCAOB standard changing the auditor reporting model.

Additionally, refer to PwC's The quarter close – Q2 2018 for additional regulatory updates including discussion of disclosure trends and SAB 74 disclosure, the General Data Protection Regulation (GDPR) and how How EU privacy regulations are impacting US companies, and discussion of the SEC cybersecurity guidance.

V. Update on tax matters

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1. New guidance on impermissible tenant service income

In Private Letter Ruling ("PLR") 201812009 issued on December 14, 2017, the Internal Revenue Service ("IRS") ruled that income earned by a real estate investment trust ("REIT") for the provision of certain amenities and services to tenants of apartment buildings owned by the REIT does not give rise to impermissible tenant service income ("ITSI") and will not cause rent received from tenants to be treated as other than rents from real property under IRC Section 856(d).

PLR 201812009 provides a number of useful updates in the ITSI area which is especially helpful given the race that many REITs find themselves in when trying to develop service offerings to help compete for tenants in the luxury apartment building rental market.

The IRS specifically notes in its analysis that the presence of the amenities does not constitute a service and any income attributable to having the amenities available to all tenants at no cost does not cause the REIT to have income from the provision of services and therefore is not ITSI. Therefore, only the income attributable to a provision of a specific service in connection with the amenities needs to be analyzed for purposes of calculating ITSI. This distinction is particularly important given the proliferation of high-end common areas available for use by tenants such as rooftop pools and lounges.

As for the services, the ruling implies that the services would be excluded from Unrelated Business Taxable Income under IRC Section 512(b)(3) for purposes of whether the income is qualifying income for REIT qualification purposes. However, the IRS specifically indicated that an exempt organization providing the same services may have unrelated business taxable income under IRC Section 512(b)(3).

For additional information concerning this issue, refer to the recent PwC Real Estate Tax Alert.

2. Today's emerging technologies for tax reform readiness

The 2017 tax reform reconciliation act is having a substantial impact on US taxpayers. Taxpayers and their advisers need strong technological support to respond to and plan for the changes made by the Act.

Internal and environmental factors, such as sweeping US tax reform, present a compelling business case for the change needed to enable the Tax function to respond with accurate information for planning, reporting, and compliance.

To secure necessary funding and articulate a clear path to an attractive ROI, an effective business case for intelligent process automation should contain certain key elements, including strategic objectives and critical success factors. In considering strategy and defining success, the tax function should be mindful of non-financial measures such as employee engagement and the ability to deliver increasingly complex tax requirements without additional support from people.

Automation is the key to making data 'work harder,' i.e., being more accessible and useful for the tax professional. Helping the workforce stay current on the emerging technologies is crucial for the tax function to efficiently leverage these technologies. (For example, companies can offer the PwC Analytics Academy or Tax Automation & Robotics Academy to groups of employees.

Refer to the recent PwC Tax Insights publication Today's emerging technologies for tax reform readiness or our upcoming tax webcasts page to learn more.

VI. Governance discussion

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1. The capital allocation dilemma

US companies are holding record sums of cash on their balance sheets. At the end of 2017, US non-financial companies held approximately $1.9 trillion of cash and liquid investments, up from $1.68 trillion in 2015. Tax reform may add to these amounts as it reduced the corporate tax rate from 35% to 21% for most companies. Although tax reform also introduces a new repatriation "toll charge" on foreign subsidiaries' undistributed earnings and profits, this amount can be paid over eight years.

With additional cash on their balance sheets, the natural question facing companies is how best to use their capital. A number of companies have announced actions intended to share the benefits of tax reform with employees, such as bonuses, increases to 401(k) matching rates and hourly wage increases. Many companies have also announced increases to their share repurchase plans and/or dividends.

At the same time, shareholder activism continues to be pervasive. Activists often pressure companies to increase share repurchases and/or dividends. As a result, companies are scrutinizing their capital allocation strategies to avoid becoming activist targets.

Ultimately, companies need an effective capital allocation strategy that is well thought-out, linked to their overall strategy and clearly communicated. The strategy also needs to take into account stakeholders' expectations, company-specific circumstances and the overall economic environment. A key element of this strategy is whether, and/or how, cash is returned to shareholders.

Share repurchases and dividends may be a key element of returning capital to shareholders. Before adopting a share repurchase or dividend plan, companies should consider the following questions:

- Does the board understand the rationale behind management's position on share repurchases and dividends versus alternative uses of capital?
- What are competitors' practices regarding share repurchases and dividends?
- Does the company understand the impact share repurchases and dividends could have on its EPS and ratios?
- Is the company comfortable that its debt and capital structure support share repurchases and dividends?
- How is management assessing the timing of share repurchases in light of the company's stock price and overall market performance?
- Do the company's share repurchases create too low a bar for the achievement of executive performance targets, particularly if incentive compensation is linked to EPS targets?
- Does the company understand the impact tax reform has on its balance sheet and how will this influence the company's capital allocation approach?
- Is the company comfortable with the robustness of disclosure around its rationale for the share repurchase and dividend program?
- Is the company comfortable that it can sustain consistent or increasing dividend payment levels?
- Does the board understand investors' expectations concerning capital allocation?

For more information

Refer to PwC's The capital allocation dilemma: Thinking through share repurchases and dividends in the new environment for more insights. This paper offers additional considerations to help boards evaluate capital allocation decisions.

VII. Technology trends and update

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1. *Experience is everything: Here's how to get it right*

Give customers a great experience and they'll buy more, be more loyal and share their experience with friends. Great. That's what every company strives for. So why are so many consumers disappointed? Call it an experience disconnect: companies tout the latest technology or snappy design, but they haven't focused on—or invested in—the aspects of customer experience that are the most meaningful.

What truly makes for a good experience? Speed. Convenience. Consistency. Friendliness. And one big connector: human touch—that is, creating real connections by making technology feel more human and giving employees what they need to create better customer experiences. People are increasingly loyal to the retailers, products, brands and devices that consistently provide exceptional value with minimum friction or stress.

The challenge: use new technology with purpose to make the experience feel more human—without creating frustrations for customers and while empowering employees.

To learn more about PwC's insights on the *Ingredients for great experiences,* refer to PwC's Consumer Intelligence Series Publication.

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