

THE NEWSLETTER OF THE BDO REAL ESTATE AND CONSTRUCTION PRACTICE

REAL ESTATE **MONITOR**



NATIONAL SECURITY COMPLIANCE IS KEY TO CROSS-BORDER M&A

By John Lash

According to REITcfe, foreign investors purchased a record \$91.1 billion in U.S. properties last year—more than double the amount they purchased in 2014. Chinese investors alone poured \$8.6 billion into U.S. commercial real estate in 2015, and CBRE analysts assert that instability in Chinese markets has encouraged capital to flow toward perceived safe havens like New York City and London.

Our RiskFactor Report for REITs suggests this influx of capital could be squeezing the U.S. real estate market and REITs; nearly two-thirds (63 percent) of REITs we analyzed cite impediments to their U.S. growth and expansion this year.

However, large cross-border real estate deals can raise a number of regulatory flags, including national security concerns falling

under the jurisdiction of the Committee on Foreign Investment in the United States (CFIUS). CFIUS reviews increased by 50 percent from 2009 to 2014. In its most recent report to Congress, CFIUS noted that 11 percent of the transactions it reviewed required mitigation. If foreign direct investment into the U.S. continues at its current clip, we can expect that upward trend to continue. Originally appearing in Mergers & Acquisitions, the following article, authored by John Lash, BDO Consulting Senior Manager, dives into the uptick in overall foreign direct investment in the U.S. and the complexity of navigating the regulatory landscape and CFIUS review process.

From Silicon Valley's bench to a seat at the table at Facebook, U.S. Magistrate Judge Paul Grewal surprised many. Judge Grewal handled several high-profile intellectual property cases between technology giants,

BDO REAL ESTATE AND CONSTRUCTION PRACTICE

BDO's Real Estate and Construction practice consists of multi-disciplined professionals who are well-versed in compliance and consulting matters. Our professionals have many years of experience in financial reporting and accounting, tax and auditing issues and are continually updating their knowledge and, therefore, are dedicated to giving timely and accurate advice.

CONTENTS

National Security Compliance is Key to Cross-Border M&A	1
What's Trending in Real Estate Around the World?	4
Q&A: How The Digital Revolution Is Impacting Hotels	5
Perspective in Real Estate	6
What Risks Keep REIT Executives Up at Night?	7
Real Estate & Construction Tax and Accounting Roundup: What to Know in 2016	8
Mark Your Calendars	10

CONTINUED FROM PAGE 1

NATIONAL SECURITY COMPLIANCE

including the Apple-Samsung patent battle and the copyright clash between Google and Oracle. But some attorneys say one of his most interesting opinions took place in a galaxy far, far away.

Foreign direct investment (FDI) into the United States has continued unabated in 2016, with Chinese buyers leading the charge. Most of these acquisitions fall into the \$1 billion-plus range, but China is also looking to the middle market to gain a strategic foothold in the U.S. And as foreign investment in the U.S. continues to swell, so too does regulatory scrutiny of cross-border transactions.

A critical element of FDI is the involvement of CFIUS. Chaired by the U.S. Secretary of the Treasury, this interagency task force within the U.S. government is responsible for the review of FDI that could result in the control of a U.S. business or critical assets, evaluating the impact of such transactions on national security.

The complexity of navigating the regulatory process has increased in tandem with international interest in taking advantage of U.S. resources and innovative technologies. These deals are making headline news more frequently, with national security concerns highlighted front and center for the general public, putting transactions, timelines, security assessments and compliance measures in the spotlight.

While transactions in many industries are subject to CFIUS review, companies in the aerospace and defense, manufacturing, critical technologies and natural resource industries file the majority of notices. However, only a small fraction of those notices (less than 10 percent) warrant binding mitigation measures.

DEMYSTIFYING CFIUS

The CFIUS review process typically begins with the parties to the transaction filing a joint voluntary notice to the committee. Although filing a notice is voluntary, CFIUS can unilaterally initiate a review of a covered transaction in critical infrastructure if the

parties do not file. The timing of a CFIUS review is an important consideration for parties when negotiating a deal and any relevant closing conditions.

The review begins with a 30-day initial assessment period, at which point a determination can be made. If there are unresolved concerns, however, the committee may initiate a 45-day investigation period. Subsequent to the investigation, if CFIUS is unable to reach a consensus on the transaction, a 15-day presidential review period begins, with the president rendering a final decision. Notably, a presidential decision has only occurred once in the last six years, ordering the divestiture of a wind-farm project involving Ralls Corporation.

According to its 2014 annual report to Congress, CFIUS reviewed 147 covered transactions, with 52 of those cases entering the 45-day investigation period. A total of 627 notices were filed with CFIUS from 2009 through 2014, resulting in 244 transactions investigated and 67 withdrawn during some stage of the review and/or the commencement of an investigation. Of particular interest within the annual report, the intelligence community has expressed moderate confidence that one or more countries or companies have implemented a coordinated strategy to acquire U.S. companies in critical technologies where the U.S. is the leading supplier.

CFIUS RED FLAGS

What constitutes a national security threat? U.S. businesses that may come under scrutiny include those that:

- ▶ Are in the defense, security and national security-related law enforcement sectors
- ▶ Provide products and services to the government with potential security or defense applications
- ▶ Constitute "critical infrastructure," e.g., energy production or transportation
- ▶ Have access to classified or sensitive government information
- ▶ Engage in activities subject to U.S. export controls

- ▶ Are in proximity to U.S. government facilities

Over the past few years, the scope of "national security" has been expanded to include U.S. economic interests and cybersecurity concerns, as well as a much broader definition of "critical infrastructure." For example, M&A activity in the semiconductor industry may be scrutinized because of U.S. dependence on the availability of chips for communication devices and transportation.

COMPLIANCE AS STRATEGY

Strategic approaches within organizations typically rely on the level of dynamism in an industry. Cross-border M&A deals involve comprehensive due diligence and analysis of the competitive landscape, as well as working to achieve synergies between the parties. With billions of dollars flowing into the United States annually through foreign acquisitions and investments, making the most of those business opportunities requires an essential component: compliance as strategy.

Organizations exploring a potential transaction typically focus on strategic approaches for position, leverage and opportunity. However, if a foreign buyer is targeting a U.S. company in critical infrastructure, that transaction should involve a comprehensive regulatory compliance strategy, ideally with buy-in from all parties.

Independent of one another, strategy and compliance are difficult commercial objectives to achieve, requiring a coordinated approach within the organization. Implementing compliance as a strategy at the inception of the transaction allows the organization to identify resources within the value chain and use synergistic resources to maintain a compliance posture. Through the validation of these core resources, the compliance framework will act as a catalyst to strategy as leverage and opportunity, shaping growth processes and alliances to reach organizational objectives.

CONTINUED FROM PAGE 2

NATIONAL SECURITY COMPLIANCE

PRACTICAL APPROACH

Organizations can meet transactional objectives by leveraging existing resources—while augmenting with outside resources as appropriate—to develop a coordinated strategy across business lines. The approach should underscore that any proposed mitigation activities are operationally aligned, ensuring that the financial and operational implementation of the strategies supports the commercial reasonableness of the transaction.

To bridge the gap between depth and breadth of experience within operating segments, organizations should leverage all personnel resources, including:

- ▶ Compliance
- ▶ Cybersecurity
- ▶ Logical security
- ▶ Physical security
- ▶ Network/Information Technology
- ▶ Supply Chain Management Product Lifecycle

Breaking down silos is imperative to compliance when dealing with CFIUS, as the cost to an organization is often less obvious than a direct monetary outflow. Operational impact, other than cost-based, may also drive decisions during deal discussions or mitigation procedures. Internal business line inefficiencies, redundancies of testing and reporting requirements, communication breakdowns, access restrictions and customer experience all require equal weight.

With this synergistic mindset, organizations must proactively address national security risks to reduce the security optics of the transaction. This strategy can include: (1) assessing appropriate risk, vulnerabilities and probability of occurrence; (2) identifying security issues and establishing a mitigation plan; (3) tactically implementing a comprehensive compliance strategy; and (4) ensuring transparency in the transaction and/or mitigation from a commercial reasonableness standpoint.

WHAT'S NEXT?

As billions of dollars are invested each year into the United States, companies must use compliance as strategy to balance commercial reasonableness objectives with national security concerns. The inflow of funds into the resource-rich U.S. infrastructure will continue to grow, and as critical technologies, natural resources and the overall economic strength of the U.S. are considered, compliance will remain a potential bottleneck to deal activity.

Organizations should evaluate the national security implications of transactions at the onset of the deal, and engage early and aggressively to address any potential issues with a coordinated strategy. Cross-border M&A has evolved to a point of multi-disciplinary teams and cross-functional projects deploying simultaneously within an organization to ensure a comprehensive security posture. With regulatory compliance remaining a key area of focus for the U.S. government, organizations should plan ahead and expect to deploy resources effectively to address CFIUS concerns.



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DID YOU KNOW...

According to [BDO's 2016 RiskFactor Report for REITs](#), REITs are feeling the pressure to secure their IT systems, with 91 percent citing security breaches as a risk in their most recent 10-K filings with the SEC. This compares to 89 percent last year and 63 percent in 2014.

Although the May jobs report from the Bureau of Labor Statistics was dim, construction employment in April rose year-over-year in two-thirds of the nation's metro areas, according to [Commercial Property Executive](#).

In spite of weak first-quarter hotel performance metrics, April hotel occupancy increased 2.2 percent year-over-year to 68.1 percent, according to [analysis](#) by [REITCafe](#).

Getting a boost from negative interest rates and direct buying by the Bank of Japan, the Tokyo Stock Exchange REIT index has gained 8.5 percent in 2016, according to [The Wall Street Journal](#).

Risks related to owning and leasing real estate were cited by 54 percent of retailers this year, a jump from 40 percent the year prior, according to the [2016 BDO Retail RiskFactor Report](#). The jump demonstrates growing concern retailers have around the impact that the rise of e-commerce has on brick-and-mortar stores.

WHAT'S TRENDING IN REAL ESTATE AROUND THE WORLD?



United Kingdom

Each quarter, *Real Estate Monitor* will feature the top trends impacting real estate in an increasingly global market, as reported by our international colleagues. For this issue, we sat down with **Russell Field, partner with BDO UK LLP**, to discuss how the lead-up to the June 23 EU Referendum, nicknamed "Brexit," is impacting the U.K.'s real estate market.

What trends are you seeing in the lead-up to the June 23 vote in London and other key markets?

We're seeing conservatism in property markets, which is typical right before elections or votes (i.e., the slowdown in the lead-up to the 2014 Scottish referendum). However, Brexit has wider implications across Europe and across continents, so investors are even more cautious this time around. Because London is the capital, the caution is perhaps felt most strongly there, but the nervousness resonates around the U.K. Manchester is leading a group of cities firmly rooted in the "stay" camp: Leeds, Sheffield, Cardiff, Glasgow, Nottingham, Birmingham, Liverpool, Bristol and Newcastle. These "second cities" are enjoying a surge in their local property markets as a result of high and climbing prices in London—a trend they do not want to stagnate come June 23, no matter the vote. There is also concern overall about a potential gap in skilled labor in the construction industry should the Brexit happen, as the workforce is heavily supported by immigrants granted free movement to the U.K. from other parts of the EU.

What are the potential negative consequences of a "leave" vote?

The industry's general consensus is that property values are likely to decline by about 10 percent, with London bearing the brunt of the hit. Valuers would have a tough time for the second quarter, since quarterly

valuations for a whole host of funds will be prepared right after the vote. Some banks are considering moving their head offices to Paris in the event of a "leave" vote, while others said they would scale back their U.K. activities.

If the U.K. votes to leave, there would be a two-year negotiation period between the U.K. and the EU, so no major changes would happen immediately. It would be a period of uncertainty—not just for the U.K., but also for the EU as a whole. Should we stay, there's a general feeling that the market would pick up pretty quickly as confidence in the U.K. returns.

Are there any potential positive consequences that could arise from a "leave" vote?

If values were to drop by the projected amount, it may present certain opportunities. First, homes would be more affordable, allowing some buyers who had hesitated as a result of the 3 percent stamp duty increase on purchases of additional buy-to-let residential property to get back in the game. A decline in values would also benefit first-time buyers who are currently unable to get on the ladder in what is fast becoming a totally unaffordable city for the younger generation.

Second, many funds have built up a significant amount of cash in the event of an investment pullout. So if there's an exodus

from funds by individuals in response to a "leave" vote, the funds will have the cash needed to pay down the withdrawals. If the U.K. stays, however, and the cash is not withdrawn, the funds will have the additional cash to invest into the property market.

How are commercial property companies protecting themselves ahead of the vote?

In general, people are waiting until after the vote to decide their next move, so property transactions have slowed over the last few months. Some investors are adding break clauses, or "Brexit clauses," to their contracts (particularly buy-to-let landlords and those buying off-plan) so that in the event of a "leave" vote in June, they have the option to exit the deal. Several new London residential developments are taking Brexit deposits, which off-plan buyers would get back should the vote not go the way they wanted. IPOs on the London Stock Exchange for U.K.-based companies have also noticeably slowed down.

In addition, some Asian investors have withdrawn their money from the markets, as their currencies have declined and calls to invest domestically increase. This is another drag on the market.



Russell Field, BDO UK

For more information on the real estate landscape in the U.K., contact [Russell Field](#), partner at BDO UK LLP, at russell.field@bdo.co.uk.

Q&A: TECHNOLOGY & HOSPITALITY

HOW THE DIGITAL REVOLUTION IS IMPACTING HOTELS

More than 148 million travel bookings [are made online each year](#), and while brand websites are still the biggest purchase source, the proportion of bookings made via merchants like Travelocity, Orbitz and Expedia is on the rise.

And on the flip side, hotels are competing more heavily with new and emerging online lodging platforms, like Airbnb and HomeAway that can offer lower prices and a unique experience.

REITs' SEC disclosures mirror these industry trends, and the resulting business risks appear to be weighing on their minds. This year, our RiskFactor Report for REITs found that four out of five (80 percent) of the hospitality REITs we analyzed highlight risks related to the rise of third-party Internet travel intermediaries. And 60 percent mentioned short-term rental share platforms.

We sat down with our client **Mark Nunneley, CEO of Ashford Hospitality Trust**, for his take on how the digital revolution is impacting REITs and operators in the hospitality sector.

Ashford invests in upper upscale and full-service hotels. How is the digital revolution, particularly third-party travel sites that sell rooms based on location and amenities over brand, disrupting revenue in the upper upscale space compared to other hotels?

In general, the digital revolution is impacting the upscale, upper upscale and luxury hotel sectors to a lesser extent than economy, midscale and upper midscale. The latter bring in more of their business from online travel agencies. Additionally, their target customers are rate-sensitive and more focused on leisure, which makes them more inclined to choose where to stay based on these factors as opposed to brand.

When it comes to what some refer to as "the Airbnb effect," the rise of the sharing



economy has hurt economy and midscale establishments more than upscale and above, since lower-rated supply drives a lot of Airbnb. A lot of our upper upscale hotels are business-oriented, so they're seeing less of an impact since the types of travelers using Airbnb generally do so for leisure and budget travel.

What are some ways you're seeing hotels adapt to disruption from ...

a. The rise of third-party intermediaries?

The challenges they pose are becoming a higher priority for the brands, as demonstrated by their investments in new campaigns on mobile apps and increased benefits for loyalty members. Upscale hotels are better suited than other segments to deliver online benefits (like mobile check-in and in-app messaging) to compete against online travel intermediaries.

b. Alternative lodging, like Airbnb?

When you compare hotels to Airbnb lodging options, the major difference is that the hotel segment is focused on delivering top-notch hospitality through on-site staff, amenities and high customer service standards. Airbnb offers a unique and, to some, more "authentic" experience for travelers. The sharing economy is an area of disruption difficult for the segment to adapt to beyond what they're doing to compete with online travel platforms, so it will be interesting to see what creative solutions arise.

How are you seeing upscale hotels leverage digital technologies to improve customer experience?

The days of one hotel computer with Internet and a printer as the standard are long gone. The number of mobile devices guests bring with them—especially those traveling for business—has never been higher, and guests have grown accustomed to free WiFi. Underscoring this trend, according to a 2014 survey by the American Hotel and Lodging Association, just 11 percent of hotel properties charged for WiFi, compared to 25 percent in 2012.

As the demand for free WiFi has increased, so have expectations of quality. Guests now want services, from mobile apps to one-touch in-room adjustments and more, that operate at time-warp speeds, and hotels are moving to make that a reality.

Are there other digital trends you expect to dominate the rest of 2016 and into 2017?

The bandwidth issue will continue to pose challenges for facilities of all levels. Hotels are in the process of figuring out how best to provide faster Internet speed while also offsetting costs. Whether that means offering more bandwidth to all customers or just loyalty members, or only offering free WiFi up to a certain bandwidth, we'll likely see even more hotels move toward the standard [connection speed of 1-2 megabytes per second](#).

PErspective in REAL ESTATE



M&A activity is up in the REIT sector across various segments.

The FTSE NAREIT All REIT Index is outperforming on a year-to-date basis, although it took a slight dip in April. Some REITs are faring better than others, with apartment REITs in New York City facing challenges because of both an oversupply of units and increased competition from new construction, *UrbanLand* magazine reports. Building valuations are high, and some buyers are enjoying more profits by purchasing companies rather than their underlying real estate assets, according to *REITCafe*.

A number of M&A deals were announced in April and May. Mortgage investor Annaly Capital Management, Inc. will buy Hatteras Financial Corp. in a cash-and-stock deal valued at \$1.5 billion and expected to close by the end of Q3 2016. Both companies are structured as REITs and have nearly 90 percent of their assets in mortgage-backed securities. The deal will help Annaly diversify and expand its adjustable-rate holdings, *The Wall Street Journal* reports.

Office REIT Cousins Properties will acquire Parkway Properties in a deal valued at \$1.95 billion. The deal will create two independent office REITs with differentiated strategies as their combined Houston assets are spun off into a new publicly traded REIT, HoustonCo, according to a news release.

Earlier this month, Northstar Asset Management Group, Inc., along with its former parent company NorthStar Realty Finance Corp., and Colony Capital Inc. agreed to merge their assets into a single REIT worth about \$58 billion. The companies anticipate approximately \$115 million in annual cost savings, according to *The Wall Street Journal*.

Apple Hospitality REIT will merge with public non-listed Apple REIT Ten, Inc. to create one of the largest select-service lodging REITs in the industry in a \$1.3 billion

deal. The combined portfolio will consist of 234 hotels in 33 U.S. states, including Hilton and Marriott branded select-service hotels—mid-tier hotel properties offering some services and amenities of full-service properties—according to a press release. Apple Hospitality has stayed active over the last year, according to *REIT.com*, selling 19 properties and purchasing seven hotels in 2015. Apple Hospitality CEO Justin Knight told *REIT.com* that with strong market fundamentals, urgency to merge in the hospitality REIT segment has waned and he described both the buy and sell side as “disciplined” in their search for strategic deals.

The JBG Companies, a Maryland-based real estate firm, is reportedly in talks to acquire New York REIT, a publicly traded firm with a portfolio of Manhattan assets, after New York’s largest office landlord, SL Green Realty Corp., pulled back from a deal last fall. According to the *Real Deal*, if this goes ahead, it would be the latest in a series of deals involving privately held real estate players acquiring publicly traded REITs.

April also saw the year’s first REIT IPO, with casino resorts investor MGM Growth Properties LLC raising \$1.05 billion. According to Dealogic, this offering was the first by a U.S.-listed company to raise more than \$1 billion since last October, when First Data raised \$2.8 billion—and could signal a thaw in the IPO market, *The Wall Street Journal* reports.

REIT segments are performing differently in the M&A market, but overall fundamentals seem strong. While no segment is in the midst of a merger frenzy, there are deals to be had in the marketplace for private equity firms with an interest in the space, if they can beat out—or partner with—a strategic investor.

Sources: Dealogic, *Forbes*, *National Real Estate Investor*, *REIT.com*, *REITCafe*, *UrbanLand*, *The Wall Street Journal*

PErspective in Real Estate is a feature examining the role of private equity in the real estate industry.

FUTURE PERSPECTIVES: WHAT TO EXPECT FROM REITS IN Q3-Q4

M&A activity in the REIT sector may prove to be robust in the second half of 2016. While the past seven years have seen a 75 percent decline in REIT deal flow compared to the seven years prior—\$14.51 billion average annual M&A volume from 2008 to 2015 versus \$27.41 billion from 1998 to 2007, according to research from Green Street Advisors—this year may see an end to the ease in deal volume. Heightened pressures from activist investors in the REIT space will increasingly cause management teams to think through operational inefficiencies and evaluate consolidation or spin-off solutions, reports *National Real Estate Investor*. Additionally, *Forbes* notes that there are currently too many REITs in the market, with more than 1,100 public and private REITs in the U.S., according to the IRS. Should market conditions remain favorable and fears around the impacts of further interest rate hikes diminish, there will likely be a steady stream, if not of growth, of real estate deals and transactions in the remainder of the year.

WHAT RISKS KEEP REIT EXECUTIVES UP AT NIGHT?

By Stuart Eisenberg

While U.S. REITs are enjoying healthy gains after a rocky start to 2016, industry executives are still contending with risks new and old.

Buoyed by a strong mix of economic fundamentals, U.S. REITs recovered in March from a slow start to 2016, outperforming the broader market and S&P index. While they continue to enjoy healthy gains, industry executives are contending with business risks both old and new, according to BDO's 2016 report on REIT risk factors, an annual analysis of the risk factors cited in the most recent 10-K filings of the 100 largest publicly traded U.S. REITs.

The industry is watching warily as instability in the bond markets along with a turbulent stock market persists, which could lead to apprehension around credit and borrowing. Risks related to indebtedness are noted by 96 percent of REITs, up from 92 percent last year and 75 percent in 2014. And credit risk, including concerns around credit ratings and the ability to secure credit, is cited by 87 percent, up from 80 percent in 2015 and 55 percent the year before.

As they keep a close eye out for hints that the Federal Reserve might institute further interest rate hikes, REITs—considered high-yield investments—remain cautious of the potential impact such a move could have on their distributable cash flows and property values. REITs also worry that they may be unable to raise the capital needed to finance new assets and drive growth. Access to capital, financing and liquidity is consistently a top concern among REITs we analyzed, and remains so this year, highlighted by 96 percent.

Competition and industry consolidation are among their top concerns this year, cited unanimously among analyzed REITs. In some sectors crowded with smaller players, an uptick in M&A could be helping to restore balance. For instance, the single-family home sector is experiencing a wave of consolidation, including the deal between



Starwood Waypoint Residential Trust and Colony American Homes that closed at the start of this year. Furthermore, fewer REITs this year (88 percent) mentioned inability to sell properties quickly in response to market shifts, reflecting a healthier seller's market.

As foreign investment continues to grab attention and headlines, REITs worry the influx in cross-border capital could be squeezing the market. Foreign investors poured a record \$91.1 billion into the market last year alone, more than twice what they purchased in 2014. Impediments to U.S. expansion and growth are highlighted by 63 percent of REITs—a figure that's also more than double 2014 levels.

While Chinese investment makes up a relatively modest portion of the pie at 10 percent of all foreign direct investment in the U.S., it was recently reported that Chinese investment in U.S. real estate has eclipsed the \$300 million mark. Foreign investors—and Chinese buyers in particular—will likely stay hungry for cross-border deals despite any wariness U.S. businesses might feel around regulatory hurdles, such as filings with the Committee on Foreign Investment in the United States (CFIUS), tax complications or political consequences associated with selling to foreign investors.

As high-profile security breaches grow more commonplace across industries, REITs seem to be feeling the pressure to shore up their technology and protect their systems. Ninety-one percent of REITs cite security breaches as a risk, up 44 percent from 2014 levels. REITs could be especially susceptible to wire transfer fraud via phishing attacks. Roughly 156 million such emails are sent daily and, without any additional training or controls in place, they can be difficult to detect. Wire transfer scams can result in significant financial loss if a company falls victim and the transaction is not blocked. This could be contributing to the 96 percent of REITs that cited worries around uninsured liabilities.

REITs will need to maintain vigilance around interest rates, market turbulence, industry reshuffling and other emerging business threats. All this points to the increased importance of innovative and adaptive management strategies to address risks in a competitive and potentially volatile landscape.

This article originally appeared in Commercial Property Executive. Access the article [here](#).



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REAL ESTATE & CONSTRUCTION TAX AND ACCOUNTING ROUNDUP: WHAT TO KNOW IN 2016

According to BDO's second annual Tax Outlook Study, 63 percent of tax directors believe the cost of compliance within the tax and financial regulatory environment has increased in the last year.

The real estate industry is no exception: according to our latest RiskFactor Report for REITs, 69 percent of REIT executives cite worries around accounting rule changes and financial reporting risks in their most recent SEC 10-K filings. Maintaining tax and regulatory compliance is a significant cost for many businesses, and for some can feel like a moving target.

Which tax and accounting developments and trends are top of mind for the real estate and construction industry this year?

FASB LEASE ACCOUNTING STANDARD

The Financial Accounting Standards Board's (FASB) new lease accounting standard, ASU 2016-02, Leases (Topic 842), was issued on Feb. 25, 2016, and is designed to bring greater transparency to companies' lease assets and liabilities. The new standard, which is effective for public companies for fiscal years beginning after Dec. 15, 2018, and for private companies for fiscal years beginning after Dec. 15, 2019, including interim periods within those fiscal years, could bring significant changes to businesses that hold large amounts of real estate, as well as landlords and REITs.

It requires:

- ▶ **Lessees** to record a right of use (ROU) asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with

classification affecting the pattern of expense recognition in the income statement. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available.

- ▶ **Lessors** to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn't convey risks and rewards or control, an operating lease results. A modified retrospective transition approach is required for lessors for sales-type, direct financing and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available.

REITs could be facing heightened uncertainty as a result of the new lease accounting standard, as it will likely impact the dynamic between landlords and tenants. The lease accounting standard is expected to influence key performance metrics and real estate strategy for businesses—retailers in particular—that occupy significant amounts of space. Businesses might be inclined to buy properties over leasing, which could create hurdles for REITs and other lessors of real estate.

PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015

The Protecting Americans from Tax Hikes Act of 2015 (PATH Act) was signed into law on Dec. 18, 2015, and contains a number of

provisions that could impact REITs' business operations. While some of these changes will be favorable for REITs, others impose limits. And all will add to the complexity of maintaining REIT status and satisfying the various compliance and reporting obligations.

In terms of favorable changes, the PATH Act expands the 10 percent tax basis safe harbor for the prohibited transaction tax by increasing the limitation to 20 percent of aggregate tax basis, provided the REIT doesn't sell property with a tax basis or fair market value exceeding 10 percent of the REIT's aggregate tax basis or fair market value over a three-year period. Additionally, it repeals the preferential dividend rule for publicly traded REITs, and provides the Treasury the authority to develop remedies for inadvertent preferential dividends or preferential dividends that were due to reasonable cause and not willful neglect.

The PATH Act also modifies treatment relating to certain debt instruments by allowing debt instruments of publicly traded REITs and interests in mortgages on interest in real property to be considered qualifying real estate for purposes of the 75 percent asset test. Income from such assets qualifies for purposes of the 95 percent income test. Qualification of income from debt instruments of publicly traded REITs will not qualify under the 75 percent income test, unless the income qualified under existing law and does not exceed 25 percent of the REIT's assets based on value.

Under the PATH Act, income generated from personal property will be considered qualifying income for purposes of the 75 percent income test to the extent that the personal property is treated as a real property for purposes of the 75 percent asset test. REITs will also be allowed to exclude from their income test calculations income generated on a hedge of an

CONTINUED FROM PAGE 8

TAX ROUNDUP

originally qualifying hedge entered into after disposition of the underlying property.

Conversely, the PATH Act prevents tax-free spinoffs in most cases when either the distributed or distributing entity is a REIT, unless both entities qualify for REIT status immediately after the spinoff or the REIT spins off a Taxable REIT Subsidiary (TRS). Further, beginning after Dec. 31, 2017, the PATH Act also returns the limitation on the value of TRS shares a REIT is allowed to own to 20 percent, reducing the limitation from 25 percent back to its pre-2008 level.

The PATH Act also limits the amount of REIT dividends that can be designated as "capital gains dividends" to the lesser of the capital gain recognized by the REIT or total dividends paid by the REIT. Finally, the PATH Act repeals the partnership audit rules under the Tax Equity and Fiscal Responsibility Act (TEFRA) and replaces it with a new entity-level audit regime that may create an entity-level tax liability that will need to be considered for purposes of ASC 740—Income Taxes.

MORE CONSTRUCTION COMPANIES ENACTING EMPLOYEE STOCK OWNERSHIP PLANS

Note: Excerpts from an article that originally appeared in Breaking Ground Magazine.

The largest industrial concentration of Employee Stock Ownership Plans (ESOPs) is in the architectural, engineering and construction (AEC) sector, with about one-third of the largest 100 ESOP-owned businesses in the U.S. being AEC companies.

ESOPs can also offer many advantages not just to employees but also employers. An ESOP is an arm's-length, fair market value transaction, so the selling shareholders will receive as much from an ESOP transaction as they would from a sale to a strategic or financial buyer. An ESOP also gives owners the opportunity to retain day-to-day management of the business and keep their legacy intact.

ALERT:

SEC APPROVES FINRA AND NASD RULES

Effective April 11, 2016, the SEC approved amendments to FINRA Rule 2310 and NASD Rule 2340 aimed at protecting investors.

Amendments to NASD Rule 2340, *Customer Account Statements*, modify the requirements relating to the inclusion of per-share value estimates for direct participation program (DPP) and non-traded REITs on account statements. Amendments to FINRA Rule 2310, *Direct Participation Programs*, make corresponding changes to the requirements applicable to public offerings of DPP or REIT securities.

These rule changes impact reporting requirements for REITs and other business development companies, requiring them to provide a valuation of their underlying investment and assets. Read the full regulatory notice [here](#).

ESOPs are the most efficient ownership structure from an income tax perspective. In an S-corporation that is owned 100 percent by an ESOP, all of the taxable income is passed through to the ESOP trust as the sole shareholder. Since the ESOP trust is a qualified retirement plan under section 401(a), the trust is tax-exempt under section 501(a).

Many AEC companies are realizing the income tax savings, ownership motivation, flexible compensation structure, efficient corporate governance and other benefits of being an ESOP-owned S-corporation. This could put them at an advantage in the competitive bid process. AEC companies that are mature ESOPs have paid off their shareholder loans and are accumulating substantial amounts of money on their balance sheet. Furthermore, many are in a position to explore mergers and acquisitions.

While not all companies are a good fit for an ESOP transaction, statistics show that AEC companies have taken advantage of these unique benefits, and will likely continue to do so.



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MARK YOUR CALENDARS

The following is a list of upcoming conferences and seminars of interest for Real Estate and Construction executives:

JUNE

June 25-29

CFMA's 2016 Annual Conference & Exhibition*

JW Marriott San Antonio Hill Country Resort & Spa
San Antonio

June 29-30

Non-traded REIT & Retail Alternative Investment Symposium

Marriott
New York

JULY

July 13-14

AltLend Summit 2016, the Investor's Forum on Innovations in Small Business and Real Estate Lending

The Princeton Club
New York

July 13-Sept. 7

NAIOP Construction Management for Developers and Owners Course
Online

AUGUST

Aug. 3-4

Sunbelt Builders Show 2016

Gaylord Texan Resort & Convention Center
Grapevine, Texas

Aug. 11-13

Think Realty Expo: Global Conference 2016

Parc 55 Hilton
San Francisco

Aug. 28-30

International Council of Shopping Centers Florida Conference & Deal Making 2016

Orange County Convention Center
Orlando, Fla.

SEPTEMBER

Sept. 26-27

NAREIT SFO Workshop

Grand Hyatt Denver
Denver

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** indicates BDO is hosting or attending this event*

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