

THE NEWSLETTER OF THE BDO REAL ESTATE AND CONSTRUCTION PRACTICE

REAL ESTATE & CONSTRUCTION **MONITOR**



BUILD MORE: R&D TAX CREDIT BENEFITS FOR CONSTRUCTION COMPANIES

By Adam Korenfield

Construction is not an industry that has historically been known for innovation—but times are changing.

The advent of “green” building and new sustainability standards, along with advances in digital technology and connectivity, have created the impetus for innovation in everything from building materials to modeling and engineering techniques.

Within the construction industry, if a company is financing activities to try to develop or improve energy efficiency, mechanical systems, process design, pilot plants, construction techniques or other products, processes or software, then it’s likely performing activities that qualify for

research and development (R&D) tax credits. Equaling as much as 9 percent of qualified spending, the federal R&D credit is available for taxpayers that incur eligible expenses in an attempt to develop or improve their products, processes, software or—more commonly in the construction industry—techniques. Companies claiming R&D credits will benefit from an increase in cash flow and earnings per share, as well as a reduction in effective tax rate.

The *Protecting Americans from Tax Hikes Act of 2015*, enacted in December 2015 (PATH Act), permanently extended and modified the R&D credit, making it more accessible to companies of all sizes. Prior to its passing, companies had to wait anxiously each time the credit expired to see if it would be

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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.

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R&D TAX CREDIT BENEFITS

extended, or if they were prevented from benefiting from it because of perceived or actual obstacles.

Even though many companies have benefited from R&D credits—the latest IRS statistics indicate that in 2012, 240 construction companies reported credits, with the average credit being just over \$100,000—some companies didn't, believing their activities failed to qualify because they weren't conducting R&D, or that their activities had to be unique from their competitors. Others, particularly smaller companies or startups, didn't seek to benefit from R&D credits because they weren't paying regular income taxes and were unaware that they could take advantage of a tax credit. Happily, the first set of obstacles—misunderstandings that overstate the requirements to qualify for the R&D credit—can be cleared up rather easily, and the second is razed by the PATH Act.

ELIGIBILITY CRITERIA

According to [BDO's 2016 Tax Outlook survey](#), the number one reason tax executives fail to claim R&D tax credits is the assumption that they aren't engaging in activities that qualify. Avoid this mistake: The construction industry participates in a

broad range of activities that may be eligible for the credit, e.g., attempts to develop or improve energy efficiency; "green" or LEED initiatives; design approaches; structural or utility systems; safety or performance; or construction processes, materials or equipment.

Generally, the R&D credit is available to companies that:

1. Attempt to develop or improve the functionality, performance, reliability or quality of a product, process, software, invention, technique or formula (business component);
2. Encounter uncertainty regarding either their capability or methodology to develop or improve the business component or the component's appropriate design;
3. Engage in a process of evaluating alternatives to eliminate the uncertainty; and in doing so
4. Fundamentally rely on technological principles, i.e., those of engineering or the computer, physical or biological sciences.

SMALL BUSINESSES: REDUCTION IN AMT

Prior to the PATH Act, the R&D credit generally could offset only regular income tax liability. For taxable years starting after Dec. 31, 2015, Eligible Small Businesses (ESBs) can now utilize the credit to offset Alternative Minimum Tax (AMT). Construction companies and their shareholders may receive cash benefits from R&D credits that were previously not available to them because of AMT obligations. ESBs are defined as privately held corporations, partnerships or sole proprietorships with average gross receipts of less than \$50 million for the three preceding taxable years.

STARTUPS: ELIGIBILITY AND IMMEDIATE REDUCTION OF FICA TAXES

For taxable years beginning after Dec. 31, 2015, Qualified Small Businesses (QSBs) can use the R&D credit to offset up to \$250,000 of the FICA portion of their payroll tax. The immediate impact and cash flow resulting from this new opportunity can

be a tremendous benefit for construction startups, many of which are paving the way for industry innovation with new project management tools and automation developments. QSBs are defined as businesses with less than \$5 million in gross receipts for the current year and no gross receipts prior to the five taxable years ending in the taxable year.

A SIMPLIFIED METHOD

The two methods of calculating the credit remain the same. Since one method—the Regular Credit method—can require certain financial information dating back to the 1980s, the amount of paperwork and reporting required may have deterred some companies from claiming the credit in the past. The more recently enacted Alternative Simplified Credit (ASC), however, provides a far simpler method. Under the ASC method, only qualified research expenses for the current tax year and the prior three tax years are needed to calculate the credit. And now, certain taxpayers can elect the ASC method on an amended return, something not allowed until recently, giving executives another reason to consider whether they're leaving benefits unclaimed.

As the construction industry continues to expand its efforts to develop the buildings, infrastructure and construction techniques of the future, construction businesses should consider whether the R&D credit can help them achieve their goals. Different companies will face varied and unique business considerations based on their size and position in the growth cycle, but many—regardless of size—can still reap the benefits from the R&D credit, and be well on their way to cash flow savings.

This piece originally ran in Construction Today.



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WHAT'S TRENDING IN REAL ESTATE AROUND THE WORLD?



Australia

Each quarter, we 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 **Sebastian Stevens, National Leader of BDO Australia's Real Estate & Construction practice**, to discuss new legislation impacting foreign investors and the overall performance of the Australian REIT market.

Can you provide an overview of the property market in Australia and how it has rebounded from the global financial crisis?

Since the global financial crisis, Australia's economic conditions—characterized by record-low interest rates of 1.75 percent, strong population growth, low levels of unemployment, strong and sustained growth in residential and commercial property prices, and an established trend toward inner-city, high-density living—have provided a popular environment for property investment.

However, Australian property markets are fragmented. Melbourne and Sydney have been strong with growing property markets underpinned by population and employment growth. Brisbane and Adelaide have experienced decent levels of growth over the same period, and the Perth, Darwin and Hobart property markets are still in low-growth or decline phases, with falling values and a significant oversupply of properties for sale.

Australian markets may have entered the next stage of the property cycle, with capital growth slowing to a much lower rate than has been seen over the past 12 months.

What foreign investment trends are you seeing in Australia's real estate sector?

An influx of foreign investment in Australian residential and commercial property is a key

contributing factor to the strength of the property market. Foreign investment in the residential real estate market tripled between 2012 and 2015—it surged from \$17.16 billion in 2012-13, to \$34.72 billion in 2013-14 and \$60.75 billion in 2014-15.

However, in 2016, a significant reform package was announced in the Australian federal budget. It introduced more stringent foreign investment rules, stricter lending requirements, increases to the foreign land tax surcharge and higher stamp duty costs. Foreign investors who dominated the property markets last year are now finding it more difficult to obtain financing. This has led to a decline in investor participation levels, which are now hovering near the average level for the past decade.

Nevertheless, foreign demand should remain strong. Although there is ongoing volatility in global markets, Australia's economic reputation makes it a safe, reliable long-term investment decision.

Can you elaborate on the new borrowing rules put in place for foreign investors?

Foreign investment has been a clear driver of Australia's housing industry. In the last year, financial regulators have expressed concern over the significant and increasing role of foreign investors, especially regarding

the inherent exposure to foreign market fluctuations and potential fraud.

This has promoted a crackdown on the investor lending segment, and major banks have recently tightened lending rules for foreign buyers—including, but not limited to:

- ▶ Halting all lending to non-residents and temporary visa holders.
- ▶ Declining loan applications based solely on foreign income.
- ▶ Increased loan application fees, which rise in proportion with the purchase price.
- ▶ Increasing the size of deposits required
- ▶ Tighter loan-to-value ratios.

This July, Australia implemented a new tax on foreign sellers with property valued at more than AUD \$2 million. Have you seen any immediate effects of this law?

Following on from the new borrowing rules, the Australian Tax Office (ATO) also introduced changes to Australia's foreign investment tax regimes. The measures involve introducing a new non-final withholding tax, along with tougher compliance and tax transparency conditions as part of the investment approval process.

New rules will apply to sales of Australian real property with a market value of AUD \$2 million or more. Vendors will incur a 10 percent non-final withholding tax for

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AUSTRALIA

all contracts entered on or after July 1, 2016, unless they obtain a clearance or variation certificate. The rules aim to strengthen the foreign resident capital gains tax regime to assist in the collection of foreign residents' capital gain tax (CGT) liabilities.

Additionally, foreign buyers will have to comply with more onerous conditions of purchase. Requirements include providing citizenship and visa details, as well as obtaining Foreign Investment Review Board clearance.

The ATO also introduced new taxes for buyers. In New South Wales (NSW), foreign buyers will be hit with a 4 percent stamp duty surcharge after June 2016 and a 0.75 percent land tax surcharge commencing in 2017. Victoria raised its existing 3 percent stamp duty surcharge and 0.5 percent land tax surcharge to 7 percent and 1.5 percent, respectively, on July 1, 2016, while Queensland's 3 percent stamp duty surcharge will kick in on Oct. 1, 2016.

Do you anticipate that the tighter lending rules and new tax regimes will have any long-term effects on foreign investment levels?

The shift in these rules will have the most dramatic effect on the upper end of the market and medium- to high-density construction markets, which generally see

larger investor participation. The tax changes will add a substantial amount to the purchase costs for foreign buyers of apartments and houses and big site acquisitions.

How is the Australian REIT market performing in comparison with the broader market?

The Australian REIT (A-REIT) market is a well-established sector with nearly 50 REITs and more than \$93 billion investment-grade assets domiciled in Australia. A-REITs have continually outperformed the broader market, as reflected by the 19 percent returns in the S&P/ASX 200 A-REIT accumulation index compared to 3 percent returns in the broader ASX 200 accumulation index over the last 12 months. Earnings growth, upward asset revaluation and the low cost of debt are the keys to success for many REITs in the sector.

What trends are you seeing in the Australian REIT market? Is there an increased interest in a particular asset class?

In the A-REIT market, the investment opportunities are predominantly spread across retail, office and industrial. While nontraditional asset classes such as pubs, data centers, storage facilities, healthcare, childcare and education facilities do not currently represent a significant proportion of the sector, they form a growing asset class that uniquely appeals to investors as it proves to be less vulnerable to wider property market and ASX fluctuations.

More than 90 percent of A-REIT property exposure is on Australia's east coast—primarily in the urban areas of Sydney, Melbourne and Brisbane. These properties will likely continue to benefit from the area's economic drivers in construction, infrastructure, retail, education, healthcare, technology, financial services and professional services.



For more information on the real estate landscape in Australia, contact Sebastian Stevens, National Leader, Real Estate & Construction, at BDO Australia LLP at Sebastian.Stevens@bdo.com.au.

DID YOU KNOW...

U.S. REITs outperformed the Dow Jones industrial average and the Standard & Poor's 500 index, achieving a 3.87 percent total return in July, according to [Globe St.](#)

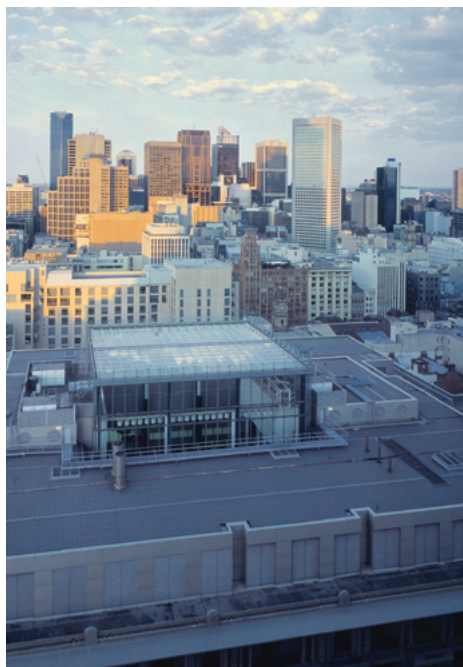
[Dodge Data & Analytics](#) indicates that the value of construction starts fell 2 percent between June and July 2016 to a seasonally adjusted annual rate of \$586.3 billion, largely due to a 17 percent decrease in the nonbuilding sector.

Housing starts increased 5.6 percent year-over-year, rising to a 1.211 million annualized rate in July—the strongest rate since February 2016, according to a Commerce Department [report](#).

According to data from the [Bureau of Economic Analysis](#), investments in office properties and hotels both increased as a percentage of GDP. In Q2 2016, investments in office properties increased 22 percent year-over-year and investments in hotels increased 19 percent.

At the end of June 2016, cost of shelter accounted for 63.9 percent of the consumer price index, which is the highest amount since 2007, according to the [Labor Department](#).

Foreign investors bought \$5.1 billion worth of apartment properties in the first six months of 2016, according to the [National Real Estate Investor](#). Although 2016 is not on track to meet the 2015 high of \$19.6 billion, foreign investment has already surpassed the 10-year average of \$5.4 billion.



PErerspective in REAL ESTATE

A FEATURE EXAMINING THE ROLE OF PRIVATE EQUITY IN THE REAL ESTATE INDUSTRY



Exit activity for U.S.-based non-traded REITs in 2016 has been

relatively modest, not least because the majority of capital raising took place during the last four years, according to *National Real Estate Investor*.

Of the \$65 to \$70 billion currently invested in non-traded REITs, nearly \$45 billion was raised since 2012. Funds may also be holding onto investments longer, rather than returning dividends or capital to shareholders, as regulatory changes requiring non-traded REITs to market have made fundraising more challenging, *National Real Estate Investor* reports.

For investments that are maturing, exit options have lately been narrower than usual. The challenging IPO market has affected every sector from technology to natural resources, and REITs are no exception. During what *The Wall Street Journal* calls the slowest year for U.S. IPOs since 2009, 2016 has so far seen just one U.S. REIT IPO—MGM Growth Properties, which raised \$1.05 billion in its April launch.

Globally, it's a different story. While the U.S. IPO market has stagnated in 2016, global REIT IPO activity is up, driven by low interest rates around the world and investor demand for stable yields amid global uncertainty. According to *REIT.com*, there have been 31 real estate IPOs globally in 2016, raising a combined total of \$6 billion, with a strong showing in Asia. Following the successful debut of Viva Energy REIT, which raised \$1 billion on the Australian Stock Exchange (ASX) in August, other Asia-Pacific REITs considering an IPO include Charter Hall Group's Charter Hall Long WALE REIT (ASX), as well as Bain Capital's plans to sell part of its Japan hotel assets through a REIT IPO (Tokyo Stock Exchange).

Despite improving U.S. equity markets, rising property prices and increasing demand for commercial real estate in recent years—factors which would normally drive IPOs—liquidation and M&A are the most attractive options for non-traded REITs looking to exit in the near term, according to *National Real Estate Investor*. Hines REIT recently announced plans to sell seven West Coast office assets to an affiliate of Blackstone Real Estate Partners VIII for \$1.162 billion, and is in the process of liquidating the remaining assets in its portfolio. Apple Hospitality REIT will buy non-traded REIT Apple REIT Ten in a deal valued at \$1.3 billion, set to close in the third quarter. And in August, Mid-America Apartment Communities announced it would acquire Post Properties in an all-stock deal valued at almost \$4 billion.

In every sector, U.S. entities are choosing sales over IPOs, as cash-rich strategic and financial investors are eager to take listings off the board at high valuations, *The Wall Street Journal* reports. As they await maturity, non-traded REITs account for a smaller share of dealmaking compared with three or four years ago, according to *REIT.com*. However, M&A activity remains consistent with levels seen during the last couple of years due to an increase in the number of public-to-public deals.

Increasing interest from activist investors, such as Pershing Square's Bill Ackman and Jeffrey Smith of Starboard Value, is driving the growth in publicly traded REIT M&A, according to financial information services provider *Bidness Etc.*

Large numbers of REITs with market capitalizations under \$2 billion make the market ripe for consolidation, as companies seek to increase their net asset value. For instance, Cousins Properties will merge with Parkway Properties in a stock-for-stock agreement valued at \$2 billion, due for completion in the fourth quarter. The deal also calls for a spinoff of the Houston-based

FUTURE PERSPECTIVES:

WHAT'S UP NEXT FOR REAL ESTATE AND REIT INVESTORS?

As long as 10-year Treasury rates remain around their current levels of 1.5 percent, new issues in the U.S. real estate sector should pick up after the November election and into the early part of 2017, according to a *REIT.com* podcast. Interest in student housing is high, but there could be increased activity in a variety of asset classes, provided there is not a significant interest rate hike in the coming months. Real estate activity in Asia and South America is expected to remain strong, while Europe will likely see lower levels of dealmaking, as investors grapple with concerns over Brexit and the Italian banking crisis.

assets into a new publicly traded REIT. High levels of dealmaking will likely continue as REITs consolidate and PE firms look to deploy their dry powder in a relatively stable market.

Sources: *Bidness Etc.*, *Value Walk*, *REIT.com*, *National Real Estate Investor*, *Reuters*, *The Wall Street Journal*, *AFR Financial Review*, *AJC*.

AS QUALITY-BASED PAY RIPPLES ACROSS HEALTHCARE, REITS RE-EVALUATE STRATEGY

By Ben Hendren & Venson Wallin



It's no secret that healthcare is undergoing a revolution of sorts right now.

But as providers and payers alike continue to absorb the brunt of the regulatory earthquake, an unexpected group is left with an aftershock: [healthcare REITs](#).

THE SOURCE OF FRICTION: SKILLED NURSING FACILITIES (SNFs)

At the center of the aftershock, on April 1, 2016, the Center for Medicare & Medicaid Services (CMS) launched its first mandatory Comprehensive Care Joint Replacement (CJR) model. The program mandates that almost 800 hospitals in 67 metropolitan statistical areas receive [bundled payments](#) from CMS for hip and knee replacements, aimed at reducing readmissions and keeping patient spending below certain levels. Hospitals are then held financially responsible for all costs, processes and outcomes within 90 days of initial hospitalization—including care administered outside the hospital walls within post-acute care providers like SNFs.

Before the CJR initiative, hospitals were required to keep patients after hip and knee replacements for at least three days in order to receive reimbursement. Under CJR, however, to avoid unnecessary hospitalizations, hospitals can waive that three-day rule—as long as patients are sent

to a SNF with a three-star [quality rating](#) or above.

CJR incentivizes increased coordination between providers, encouraging hospitals to send patients to SNFs based not on previous relationships, but instead on their quality of care. SNFs have been forced to re-evaluate their services—either by cutting or improving the ones dragging down their star rating—or risk being avoided by both providers and investors.

IMPLICATIONS FOR REITS

Concern around healthcare reform is not new for REITs, but has grown over the last year. According to the [2016 BDO RiskFactor Report for REITs](#), 13 percent of the largest 100 publicly traded U.S. REITs cited healthcare reform as a risk to business in their most recent SEC 10-K filings, compared to 11 percent in 2015.

The shift to quality-based reimbursements—with additional bundled payment mandates coming down the pike—is likely to, at least in the short term, result in shorter lengths of stay and lower reimbursement rates that could make SNFs and other healthcare operators less profitable.

And while healthcare properties overall are expected to sustain growth—aided by about 77 million baby boomers headed toward retirement—healthcare REITs are re-evaluating their investment strategies, especially with regard to the SNFs in their portfolios.

REITs' responses to the shift in healthcare are following two trends:

► **Portfolio diversification:** Some REITs are reconsidering their focus on SNFs, and are instead pivoting toward a more diverse mix of properties, including medical office buildings and private pay senior housing properties, which are not reliant on government reimbursements.

► **Divesting properties:** Other REITs have chosen to spin off their SNF portfolio entirely so they can focus on properties with greater potential for growth and isolate or divest of their SNF exposure.

Additionally, healthcare REITs are now more focused than ever on maintaining strong relationships with high-quality facility operators.

REITs that invest in SNFs are considering the value of maintaining flat rents or even rent reductions in exchange for building relationships with more stable operators that have higher quality ratings in order to mitigate the risk associated with the changing SNF reimbursement model. For REITs working with lower-rated facilities with higher readmission rates, higher lease coverages and capitalization rates are warranted.

WHAT'S NEXT?

Mandatory bundles for hip and knee replacements are just the first crack to hit the fault line. In fact, U.S. Secretary of Health and Human Services Sylvia Burwell has set the goal of tying 90 percent of all traditional Medicare payments to quality or value by 2018.

Additional mandates coming down the pike include mandatory cardiac care bundles, set to begin in the summer of 2017. As bundled payments continue to create new trends in care plans, healthcare REITs are likely to direct their dollars according to where the least reimbursement risk lies.



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SOMETHING'S PHISHY...

5 Ways Real Estate & Construction Companies Can Mitigate Email Phishing & Social Engineering Risks

In Q1 2016:

3⁺ DOZEN
BUSINESSES
VICTIMIZED
by phishing attacks on
EMPLOYEE TAX RECORDS

250%
INCREASE IN UNIQUE
PHISHING WEBSITES*

4x MORE
email antivirus
DETECTIONS*

*Over the same period last year

While real estate and construction companies may not be the usual target, they're not immune to cyberattacks. Though they don't store large quantities of personally identifiable information—the most straightforward quarry for financial gain—phishing or social engineering scams can lead to wire fraud and significant financial loss. Avoid becoming hackers' catch-of-the-day by adding these five tips to your cyber tackle box.

Catch a phishing or social engineering scam before you take the bait:

1

Implement an External Email Header

Append a message to the top of all emails from an external source so employees scrutinize outside content, checking for red flags.

2

Improve Detection Capabilities

Update the rules on your firewall and Intrusion Detection System. Consider using Domain-based Message Authentication, Reporting & Conformance technology. Validate emails through Sender Address Verification.

3

Train and Test Employees

Educate employees on phishing threats and test their preparedness through mock malicious email campaigns.

4

Strengthen Internal Controls

Put checks and balances in place to authenticate vendor or other third-party requests, such as: 1) Require more than one person to authorize a transaction, 2) Validate the vendor's name, Tax ID, address and internal contact, and 3) Contact the outside party directly to verify requests for payment.

5

Apply a Risk-Based Approach to Analyzing User Types

Assess users' roles and required access to sensitive applications to determine what level of controls to apply. Assign levels of access and authentication according to who is most vulnerable to phishing attacks.

So ... What else can you do?

For assistance mitigating phishing or social engineering risks, contact:

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For more information, visit: www.bdo.com/services/consulting/forensic-technology-services

MARK YOUR CALENDARS

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

SEPTEMBER

Sept. 26-27

NAREIT SFO Workshop

Grand Hyatt Denver
Denver

Sept. 28-30

Institutional Investor Real Estate Conference

Grant Hyatt Washington
Washington, D.C.

Sept. 29

NYC Real Estate Expo

Hilton Hotel
New York

OCTOBER

Oct. 5-6

Real Share National Investment & Finance

The Roosevelt
New York

Oct. 6-7

Real Estate Private Equity Forum on Land & Homebuilding

Las Vegas

Oct. 18-22

IREM Fall Leadership Conference

Hilton San Diego Bayfront
San Diego

Oct. 19-22

CREW Network Convention & Marketplace

New York Hilton Midtown
New York

NOVEMBER

Nov. 2

PrivCap Game Change: Real Estate 2016

University of Chicago: Gleacher Center
Chicago

Nov. 15-16

PERE New York Summit 2016

Convene Conference Center
New York

Nov. 15-17

REITWorld: NAREIT's Annual Convention for All Things REIT*

JW Marriott Desert Ridge
Phoenix

Nov. 17

Capital Markets in Real Estate

The Pierre
New York

** indicates BDO is hosting or attending this event*

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