INSIGHTS FROM THE BDO REAL ESTATE & CONSTRUCTION PRACTICE

HOW CONSTRUCTION CAN CAPITALIZE ON OPPORTUNITY ZONES

By Maureen McGetrick

As 2019 approaches its final months, construction firms may start to see an uptick in interest for projects in opportunity zones.

Enacted as part of 2017 Tax Reform, the opportunity zone program began attracting significant investor interest after the IRS released clarifying guidance about the program's rules in October 2018 and again in April 2019. While additional IRS guidance is still expected, one thing is certain: 2019 is the prime time to invest in opportunity zones to receive the program's full tax benefits. Consequently, eager investors have begun pouring capital into qualified opportunity funds (QOFs)—the investment vehicle to participate in the opportunity zone program.

As QOFs close and begin putting their cash to work, they'll need to find qualified construction firms to break ground on projects. This will likely cause a surge in demand for new projects in opportunity zones, which gives construction firms potential to win sizable engagements. Despite the opportunity, construction firms shouldn't get caught up in the hype—they'll need to take steps to avoid exposing themselves to new risks and liabilities that the opportunity zone program could create.

We've outlined a few of the key considerations for construction firms seeking opportunity zone projects as well as the existing industry headwinds they'll need to navigate.

HOW "SUBSTANTIAL IMPROVEMENT" COULD INFLUENCE CONTRACT NEGOTIATION

Even though many construction firms aren't directly investing in opportunity zones, they still need to understand the opportunity zone program's rules to protect themselves against potential liabilities. For example, let's examine the "substantial improvement" rule and explore how it could impact contract negotiation and expose firms to disputes.

Among other criteria, assets held by a QOF in an opportunity zone must either meet the "original use" or "substantial improvement" requirements in order to qualify for the program's tax incentives. If a structure has been vacant for five years before being purchased by a QOF—or was a new building under construction at the time of purchase by the QOF—it meets the "original use" requirement. Structures that do not fit the "original use" requirement must meet the "substantial improvement" requirement, which means that the value of the structure must be doubled—not including the value of the land it sits on—within 30 months after purchase by the QOF.

The 30-month deadline to meet the substantial improvement requirement means that QOFs may demand tight timelines in project contracts with builders and may be eager to start construction after purchase. Builders shouldn't let the QOF's eagerness push them into signing a contract without usual due diligence. Before agreeing to any timeline, builders should determine for themselves whether it's feasible to complete a project within the proposed timeline. If the project takes longer than expected, QOFs could be quick to raise a dispute to recoup losses incurred from the potential loss of eligibility for the opportunity zone tax incentives. Builders should negotiate for contract language that protects them if the project runs into delays outside of their control to avoid ending up in a potentially costly dispute.

Since opportunity zone properties may be in significant disrepair when a QOF purchases them, builders may also need to spend extra time inspecting the structure prior to signing a contract to uncover any hidden faults that could otherwise delay construction or increase project costs.

In some cases, builders may need to decline projects that seem too risky or have unrealistic, rigid timelines for the project's scope. For a deep-dive into how construction firms can prevent disputes, read our Roadmap for Preventing Construction Disputes.

NAVIGATING CHRONIC LABOR SHORTAGES, TRADE TURBULENCE

In addition to new areas of project risk, construction firms will also need to contend with existing industry issues—namely, tariff disruptions and skilled labor shortages.

Tariffs on foreign steel and aluminum have increased input costs for builders, eroded profit margins and complicated contract negotiations. If they haven't done so already, builders should reexamine their supply chains to determine whether they can shift import of a good subject to tariffs to a country with which the U.S. has a friendlier trade relationship. If they can't adjust their supply chains, they may have to accept slimmer profit margins until tariffs abate—which looks unlikely in the current turbulent climate. For more on how companies can navigate trade turbulence, read our Top 10 Considerations for Customs Planning in 2019 and Beyond.

Developers have been dealing with skilled labor shortages for years—as the demand for skilled craftspeople has continually increased, fewer young people are entering the industry. Potential recruits just don't see construction as an attractive and viable career option, especially when other sectors are considered more tech-savvy and offer perks that appeal to millennial workers. This gap has hindered productivity, despite otherwise high demand for projects, and hamstrung firms' ability to capitalize on new opportunities. To attract the next generation of workers, construction firms will need to make a compelling case for more people to pursue careers in the sector and demonstrate a commitment to new technology and innovation.

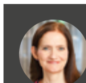
LOOKING AHEAD TO 2020

The opportunity zone program could see additional changes depending on which party controls the executive and legislative branches of government after the 2020 election. Critics of the opportunity zone program say it doesn't include any requirements for creating a positive impact on existing residents of communities in opportunity zones, and that the program will just accelerate gentrification to current residents' detriment. After 2020, Congress could add new economic or environmental requirements that QOFs must fulfill to qualify for the program's tax incentives, which could slow or stall project development.

For instance, if opportunity zone investments are required to create jobs to qualify for the program's tax incentives, the QOF might need more time to model the outcome of a project before breaking ground.

To combat climate change, Congress may mandate that new structures must be built with sustainably sourced materials or have tech-enabled, environmentally friendly systems. Some builders may not have experience working with these kinds of materials and may not think they can complete a project using an unfamiliar material—especially within a tight timeline to meet the substantial improvement requirement. Builders may need to subcontract the work to firms that have experience building with these kinds of materials or engage with outside experts to ensure the project goes smoothly.

Builders pursuing opportunity zone projects should monitor the 2020 elections and the aftermath closely. If it looks likely that Congress will add environmental or economic requirements to the program, observant builders could kick off conversations with appropriate experts and their potential clients so they can get a head start on adapting to the changes.



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