WINTER 2019
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THE NEWSLETTER OF THE BDO REAL ESTATE & CONSTRUCTION PRACTICE

REAL ESTATE & CONSTRUCTION MONITOR

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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.

SEIZE THE OPPORTUNITY (ZONE), BUT KEEP YOUR HEAD ON STRAIGHT

BDO's Stuart Eisenberg and Marla Miller demystify the new vehicle and recommend ways in which REITs can take advantage of their scale when investing in qualified properties.

The IRS defines an opportunity zone as an "economically distressed community where new investments may be eligible for preferential tax treatment." The Treasury has certified nearly 9,000 of these districts across all U.S. states and its territories, including the entire island of Puerto Rico. An opportunity zone designation has the potential to trigger a rush of investment activity and is intended to help revitalize neglected areas.

A qualified opportunity zone fund is an investment vehicle that must invest at least 90 percent of its assets in businesses that operate in a qualified opportunity zone, either by acquiring stock or a partnership interest. The fund can also make direct investments in properties and real estate located within a qualified opportunity zone. REITs and other

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OPPORTUNITY (ZONE)

operators are forming opportunity zone funds to access the capital expected to be generated by this program to acquire and develop properties.

WHAT ARE THE CORE INCENTIVES FOR INVESTORS?

Taxpayers can defer taxes by reinvesting capital gains from an asset sale into a qualified opportunity fund. The capital gains will be tax-free until the fund is divested or the end of 2026, whichever occurs first. The investment in the fund will have a zero-tax basis. If the investment is held for five years, there is a 10 percent step-up in basis and a 15 percent step-up if held for seven years. If the investment is held in the opportunity fund for at least 10 years, those capital gains would be permanently exempt from taxes.

WHAT DO INVESTORS NEED TO BE WARY OF?

While opportunity zones offer enticing benefits, tax savings should not be the only factor influencing the decision to invest or break ground on a new development. A bad deal is still a bad deal, and not all qualified investments are worth pursuing. As investors scope out opportunity zones, they should assess the potential investment with the same level of due diligence they would use for any other deal. Questions to consider include: Are the area's property values and income levels likely to grow? Does the developer or business have an established track record?

Investments in opportunity zones also have associated risks, just like any other investment. Larger qualified opportunity zone funds and ones established by experienced real estate owners and developers like REITs will have an advantage in this arena.

MORE ANSWERS TO COME

Investors should look out for additional IRS guidance on opportunity zones before the year closes. One of the remaining questions relates to "churning" investments, or the time period investors have to reinvest capital gains in a qualified opportunity zone after recognizing the gains from the sale of another qualified opportunity zone asset. The proposed regulation suggests this will be a 180-day period, but confirmation is still pending and could influence investors' next steps.

To maximize the potential benefits, taxpayers must invest in a qualified opportunity fund before Dec. 31, 2019. While investors shouldn't blindly rush into opportunity zones, the clock is ticking to take full advantage of the tax savings.

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BLOCKCHAIN'S IMPACT ON THE FUTURE OF REAL ESTATE AND CONSTRUCTION COMPANIES

By David Butcher

For the real estate and construction industries, sensors, data and automation will increasingly define construction projects, as well as cityscapes. Illustrated by the fact that there are currently more than 1,000 on-going smart city projects around the world.

The emergence of the connected city leads to many new possibilities—and challenges—for the real estate and construction industries. For example, how to integrate and leverage smart features, how to safeguard personal data and how to create a seamless interaction between various systems,

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BLOCKCHAIN

including individual buildings and city infrastructure like transport and energy systems.

I advise several blockchain companies and follow the evolving ecosystem closely. From personal experience it is clear that blockchain is about much more than cryptocurrencies and payment services. By 2020, there will be 600 recognised smart cities around the world and blockchain can underpin many, if not most, of the processes that will make those cityscapes smart.

The question becomes: if blockchain is going to be the foundation of smart cities, what does that mean for construction and real estate companies?

THE GROWING CITY-SCAPE

More than half the world's population now lives in cities. Before the middle of the century, that number will jump to two-thirds.

While cities account for the bulk of many countries' economies, they also present administrative, organisational, logistical, social and environmental challenges.

Smart cities that involve the use of Information and Communication Technologies (ICT) as well as Internet of Things (IoT) and other related technologies has been heralded as the way to mitigate at least some of these issues.

However, smart city technologies like ICT and IoT come with their own conundrums. For example, how the various systems that 'live' within a smart city environment interact with each other and individuals. How does a smart building, for example, 'talk' with a driverless car, know you, the passenger, has the right to enter and let the vehicle through the outer gates? Or how does one automate and democratise the use of energy in a building, so that inhabitants can choose if they only want to use locally produced renewable energy?

The answer is that without efficient, protected data transfer and proper use of data, most smart city initiatives and technologies will fall short.

BLOCKCHAIN TO THE RESCUE

All of which brings us to blockchain. For the smart city revolution to reach its potential, it needs horizontal integration of individual services that is a) highly automated, b) highly secure and c) allows for streamlined, accountable transmission of data. Using buildings as an example, they need to be able to collect data as

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BLOCKCHAIN

well as exchange it with other buildings, power delivery systems, driverless vehicles, weather forecast systems and vice versa. Some of this data will be personally sensitive, some financial, and some business-related.

One possible solution is for individuals to have a blockchain-based **'self-sovereign identity'** (SSI) - a consolidated digital identity. The goal is to provide individuals with a wholly unique and safe ID also helps store data, in place of the fragments that each of us currently have scattered across different pulci and private organisations, applications, and websites, with little to no control over their storage, updating, or sharing. Not to mention the risk of losing control of data to hackers.

Without delving too deeply into the technology, blockchain's decentralised Distributed Ledger Technology (DLT), distributed key management and peer-to-peer encryption technology is regarded as about the closest to unhackable we know today. It also enables the use of smart contracts with an IF/THEN structure (If A happens THEN B happens automatically). In other words, blockchain could potentially automate many of the processes and interactions between systems that smart cities will rely on. Simultaneously, it could allow for secure logging of data and data transfers within and between systems.

While still in the early stages, the potential is underscored by the fact that large corporations are engaged in developing these aspects of smart cities. For example the Chinese e-commerce giant JD, **who has opened a dedicated smart city research centre with a focus on blockchain and AI.**

Country and city governments are also backing the technology. Sweden, the UK, USA, UAE, to name but a few. Perhaps the best illustration of the potential public organisations see in blockchain-driven smart cities comes from China. The country, which has been solidly against cryptocurrencies, **looks set to integrate blockchain in many smart city projects**, including **the $380 billion development of Xiongan.**

THE MANY USES OF BLOCKCHAIN

While some of the above is a glance into the crystal ball at what the future may hold, the construction industry need not wait with integrating/trialling blockchain technology. It already has several uses that can alleviate current bottlenecks and inefficiencies.

During construction projects, blockchain can add transparency and efficiency. This is doubly the case for the **construction supply chain**. Blockchain also shows potential in areas such as logistics and storage, **payments**, **contracts**, and **fleet management**.

Logistics and storage aspects of construction projects alone could see savings in six or seven figure range by using blockchain solutions, depending on the size of the specific project, while making the whole process completely transparent to all stakeholders.

Real estate companies can employ blockchain-based **building maintenance**, **management**, streamline **contract processes** and manage land registries. The latter is currently **being tested in Georgia**.

FROM TENANT TO USER?

For both real estate and construction companies, it is perhaps worth looking at the emergence of smart cities and new, disruptive technologies from a bird's eye view. They, along with changing customer demands, indicate that both industries are on the cusp of profound changes.

In the previous century construction projects and the finished product were, while not completely cut off from their surroundings, not nearly as integrated with other systems as is the case today. Furthermore, the tenants were generally less concerned with or interested in knowing how a project was completed and the number of systems within, for example, a newly constructed building, they could interact with and manipulate was rather limited.

Today that is changing. Tenants increasingly want flexibility, control and transparency without sacrificing ease-of-use. To meet changing demands, construction and real estate companies may need to rethink how they view their customers. Instead of as tenants, they are end-users—similar to the business-customer relationship found in the technology industry. As is generally the case within the technology sector, long-term future success in smart city environments relies not only on your products (buildings/infrastructure projects), but also how they can be integrated with other systems and on your subsequent use of the data that your solutions generate to gain insights and identify new business opportunities.

Data is 'the new oil,' and construction and real estate companies are sitting on what is the equivalent of a sizeable chunk of the world's resources. Historically, they have struggled to make full use of that resource, and perhaps blockchain's biggest future boom for both industries is how it can allow those companies to collect and process data in new ways to boost innovation and drive new solutions.

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NAVIGATING THE NEW AGE OF RETAIL REAL ESTATE

By Stuart Eisenberg and David Berliner

Plagued by seven straight years of unprofitability, Sears filed for bankruptcy at the urging of banks that hold the retailers' debt this October. Near the end of the year, Sears will close 142 unprofitable stores in addition to the previously announced closure of 46 stores.

Sears joins a long list of retailers shuttering storefronts this year. In the first six months of 2018 alone, more than a dozen retailers with 20 stores or more filed for bankruptcy and closed a total of 3,838 stores according to **Retail in the Red**, BDO's biannual bankruptcy update.

Despite strong underlying economic fundamentals and high consumer confidence, brick-and-mortar retailers have continued to suffer. A confluence of factors are to blame for retail's decline, including: burdensome levels of debt, the rise of e-commerce and rapid delivery, shifting consumer preferences, and younger generations spending more on experiences rather than on physical goods.

ARE RETAIL LANDLORDS FEELING THE IMPACT OF THEIR TENANTS' FINANCIAL HARDSHIPS?

The real estate industry is keeping a close eye on retail's restructurings and bankruptcies. Many large owners and operators of malls—including retail REITs—have experienced financial damage due to retail vacancies and declining demand. Real estate owners that have older malls or lost anchor stores—like Bon Ton, Sears, or Macy's—at many different properties in their portfolios were the hardest hit.

HOW ARE RETAIL OWNERS, OPERATORS—INCLUDING RETAIL REITS—RESPONDING?

One approach gaining momentum among retail REITs to refresh retail properties and fill vacancies is designing a "reimagined mall." With the goal of increasing foot traffic, many mall operators are redeveloping and repositioning lagging properties to adapt to changing consumer tastes. This generally involves adding dining and entertainment options and shifting some of the property for new uses, including apartments, hotels, fitness centers, wellness, office buildings, distribution space, and even supermarkets like Whole Foods.

While redeveloping and repositioning sounds like a winning strategy on paper, there are significant hurdles to execution. The largest stumbling block to launch such projects is access to adequate investment capital and prior expertise executing similar initiatives. Retail REITs and property owners may not be able to undertake such an initiative on their own, and consequently, may pursue a sale or become an acquisition target for a buyer that has the resources. For instance, following Brookfield Property Partners' acquisition of retail REIT GGP, Brookfield **plans to expand** GGP's top-tier properties, while adding office and other mixed-use spaces to less successful malls.

Developers constructing new retail properties are factoring in the future of retail into their blueprints. In Florida, a proposed project for what would be **the largest mall in the country** plans to include an indoor ski slope, submarine pool, and other unconventional attractions. The cost implications for such a project, however, are potentially enormous. The American Dream Meadowlands, a similar project first proposed in 2003, faced numerous legal and financial setbacks **that have delayed** its opening to Spring 2019.

BDO'S TAKE: WHAT TO EXPECT THROUGH 2019

Even if retailers finish the year with strong sales, BDO projects more bankruptcy announcements and store closings before the new year. The future of retail is changing, and real estate owners and operators that embrace multiuse space will be best positioned to attract the next generation of consumers.

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4 CHANGING REALITIES OF HURRICANE SEASON FOR HOTELIERS

By Clark Schweers

Only a year has passed since the costliest hurricane season on record in the U.S. took thousands of lives and amounted in over US$306.2 billion in damages.

The hospitality industry was among the hardest hit from the year's three most significant storms: Hurricanes Harvey, Irma and Maria. Hotels experienced—and many are still recovering from—physical property damage, business interruption losses and long-term impacts on occupancy rates.

Now, it's déjà vu. Hurricane Florence—the first major hurricane of 2018—made landfall in the Carolinas in September. Hard-hit areas accumulated over 30 inches of rainfall, and more than 1.4 million people experienced extended power outages. This month, Hurricane Michael threatened the Florida Panhandle, hitting the coast as a Category 4 hurricane.

When a hurricane strike is looming, protecting the safety and well-being of guests is the hotel industry's number one priority. While the core elements of an effective natural disaster response plan have not changed dramatically in the past year, hotels are encountering new and worsening risks and experiencing a shift in government response, prompting many to revisit their insurance policies and dedicate more resources to disaster response.

With more than a month left to hurricane season, hotel risk managers should consider four changing realities to better prepare for the remainder of the hurricane season:

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HURRICANE SEASON

1. The frequency and severity of extreme weather events are increasing—and top business leaders are taking an active role.

Hotels are facing natural disasters and dealing with the fallout on a more consistent basis. To adapt to this reality, risk managers are no longer the only stakeholders involved in developing disaster response plans. Corporate boards and C-Suite executives of multinational hotel companies are increasingly playing key roles in deciding how to mitigate property damage risks and business interruption losses.

2. Mandatory evacuation orders are becoming more common, but not all insurance policies offer full coverage for losses incurred during an evacuation.

Authorities are declaring states of emergency and issuing mandatory evacuation orders earlier than ever before, erring on the side of caution to protect human life. Hotels could be evacuated for several days, or even a week, prior to the storm making landfall. While there are avenues for hotels to recoup financial losses incurred during an evacuation, insurance policies are not always clear about the coverage provided.

Oftentimes, coverage begins the moment a hurricane makes landfall, which could leave hotels without grounds to recover financial losses in the days leading up to the storm. Protection and Preservation coverage allows for cost recovery for activities such as boarding up windows and sandbagging vulnerable areas, but the lost business associated with closing early may or may not be covered as part of this policy. Proactively discussing this issue with insurance carriers and brokers ca n help hotels reduce unwelcome surprises after an extreme weather event.

3. Recovery and financial losses don't end the moment business resumes.

In the midst of a storm and in the immediate aftermath, a hotel's first priorities are accounting for the safety of its guests, restoring power, repairing physical damage and resuming operations. But after the lights come on and all systems are up and running, the financial strain of a natural disaster is likely to persist.

Hotels are in the business of tourism, and occupancy rates rise and fall depending on the attractiveness of the destination. Some hotels are protected by loss of attraction insurance, which allows companies to make a financial claim if something that drives business to your asset has been impacted. If an airport, convention center, sporting events center or preeminent tourist attraction is under repair, hotels may recover lost revenue.

A severe weather event could decrease traffic to a location for a significant period of time. Travelers may be reluctant to visit an area still rebuilding from a natural disaster. Many hotels' insurance policies include an extended period of indemnity provision, which accounts for the time it takes to regain guests and restore normal occupancy levels. After last year's devastating hurricane season, hotels found that losses can go well in excess of the 60 days, or even 180 days, that most policies cover. In many cases, hoteliers are looking to extend their policies to cover one full year.

4. Storms that have lower category designations can still produce significant financial losses.

Many people—seasoned hotel executives included—breathed a sigh of relief recently when Hurricane Florence was downgraded from a category 4 to a category 1. What few people understand, however, is that wind speed is the only factor considered when a storm is categorized. Rainfall and flooding, the primary causes of storm-related deaths and damages, are not reflected in the hurricane's category. Hotel executives should take precautions and consider all elements of a storm when preparing for disaster response.

With the first major storms of the year behind us, hotels are staring down the rest of hurricane season, which ends November 30. To meet the challenges ahead, hoteliers should take steps to clarify their insurance policies and refresh their natural disaster response plans.

This article was originally published in Hotels Magazine. You can view the original **here**.

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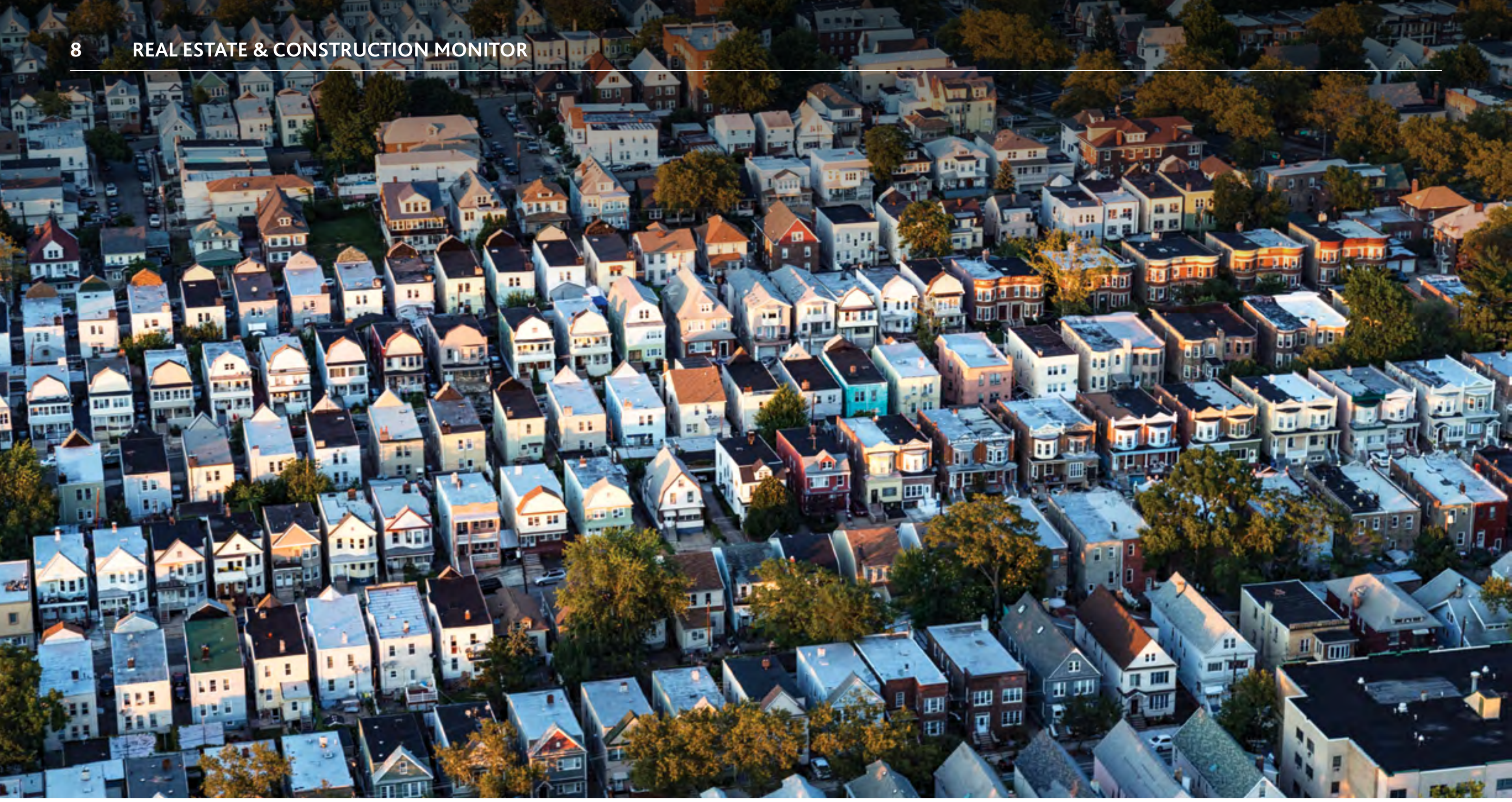

TAX REFORM & TARIFFS WIDEN THE AFFORDABLE HOUSING GAP

By Joseph Canataro and Kyle Paisley

The U.S. has an affordable housing gap, and the combined impact of tax reform and tariffs could make it a lot worse.

What's the scope of the current supply gap? The National Low Income Housing Coalition reports a shortage of 7.2 million affordable and available rental homes. This means that there are only 35 available units for every 100 extremely low-income renters (ELI). A household is characterized as ELI when their income is at or below the poverty guideline or 30 percent of their area median income (AMI). While the severity of the supply shortage varies greatly by state, the housing affordability gap stretches nationwide.

WHAT'S TAXING THE AFFORDABLE HOUSING MARKET?

Last year's federal tax overhaul is the largest factor projected to negatively impact affordable housing development. The reduced corporate tax rate from 35 to 21 percent lowered the value of low-income housing tax credit (LIHTC) investments. Housing experts initially estimated tax reform could cut the growth of the affordable housing market by more than 230,000 units over the next decade.

While the reduced corporate tax rate has the most direct impact on LIHTC, it's not the only tax change affordable housing developers are watching. The current tax code reduces the alternative depreciation system (ADS) cost recovery period for residential rental property from 40 to 30 years. Most LIHTC partnerships will elect under Section 163(j)(7)(B) to use the real property trade or business exception to the net business interest expense limitation. This election requires the use of ADS instead of the MACRS depreciation method, which has a useful life of 27.5 years for residential rental property.

With the one-year anniversary of the new tax law fast approaching, how has the affordable housing market shifted? Shortly after the 2016 presidential election, LIHTC pricing trends began their first sharp decline in anticipation of a reduced corporate tax rate. Pricing trends have stabilized and remained steady since March 2017, with average pricing fluctuating between 91 cents and 93 cents per LIHTC. Prior to the election, pricing was at a high over $1 per LIHTC. The reduction in LIHTC pricing increases need for other financing and funding from federal, state and local programs to support future affordable housing development.

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AFFORDABLE HOUSING GAP

TRADE DISPUTES ABROAD RAISE SUPPLY COSTS AT HOME

In addition to tax changes, affordable housing developers also face increased construction costs of future affordable housing projects and those already in development. The price of lumber, steel and aluminum—all essential building materials—climbed steadily as a result of the ongoing trade disputes.

The cost of 1,000-feet of western Canadian lumber in June was up nearly 80 percent over the past 12 months, according to data from trade publication Random Lengths. Lumber prices first started rising in October 2015, when a decade-old softwood lumber agreement between the United States and Canada expired without a replacement. The Trump administration's 20 percent tariff on Canadian lumber accelerated the commodity's price hike. An overall reduction in the supply of Canadian lumber due to rail slowdowns and tree disease have also contributed to the cost increases.

After this summer's record highs, lumber prices have started to settle. There is renewed hope that the U.S. and Canada can reach a new softwood agreement as well. U.S. and Canada trade relations are showing signs of improvement, with a tentative agreement to replace NAFTA with the United-States-Mexico-Canada Agreement (USMCA) in motion. Progress in NAFTA renegotiations have renewed hope that the United States and Canada could also reach a new agreement on softwood lumber trade agreement.

The United States also began imposing tariffs on imported steel and aluminum of 25 percent and 10 percent, respectively. Construction costs are expected to rise modestly as a result, particularly for the development of high-rise assets that require far more steel and aluminum than multi-family townhouses. Trade tensions may be easing in North America, but the outlook for global trade relations remains uncertain. For affordable housing developers, the question remains: Will the trade disputes reach a resolution, or are the tariffs here to stay?

LEGISLATIVE BRIGHT SPOTS FOR AFFORDABLE HOUSING

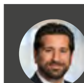
The future is not all doom and gloom, however. Congress has already taken measures to address affordable housing advocates and developers' concerns. In March 2018, Congress increased the LIHTC volume cap by 12.5 percent with the passage of *The Consolidated Appropriations Act of 2018*. The four-year temporary volume cap increase does not fully mitigate the impact of tax reform on affordable rental housing development and supply, but it does improve the outlook.

The March 2018 Act also included a new income-averaging set-aside option for LIHTC properties. Under the new option, income and rent limits for at least 40 percent of the units must average 60 percent or less. The new legislation will assist an owner's ability to offset lower rental revenues where certain funding sources may require lower set-aside for a number of rental units with greater rental revenues from units at 70 or 80 percent AMI. The change will also provide relief to owners that are acquiring new affordable housing developments or rehabilitating existing properties where certain units could be 'over income.'

CHANGES STILL AHEAD

The affordable housing sector has several other policy changes on their wish list. There are bipartisan efforts in Congress to go beyond the 12.5 percent increase in volume cap allocated federal LIHTCs passed this March and obtain a 50 percent increase. Additionally, there are appeals to establish a minimum 4 percent rate for LIHTC used to finance acquisitions and bond-financed developments.

If enacted, both changes would improve the outlook for the development of new affordable housing units. As the market currently stands, the fallout from tax reform and tariffs still present a considerable barrier for new developments. With increased construction costs and a tax code that makes LIHTC investments less attractive, 2019 will not be the year the U.S. bridges its affordable housing supply gap.



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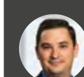

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