

CONSTRUCTION & REAL ESTATE INSIGHTS



Build More: R&D Tax Credit Benefits For Construction Companies

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

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

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.



Build More: R&D Tax Credit Benefits For Construction Companies? cont.

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.

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Perspective in Real Estate

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 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.

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