Commercial Real Estate
Hot Topics
Reduce Taxes. Maximize Cash Flow. Minimize Risk.
CBIZ
MAY 2017 | ISSUE NO. 07

CBIZ's Real Estate practice is uniquely positioned to help you minimize risk and capitalize on market opportunities.

We work with owners, managers, operators and investors, as well as commercial real estate developers and partnerships in all of the major CRE sectors: retail, office, hotel, multi-family, shopping centers and real estate investment trusts.

FINANCIAL SERVICES

INSURANCE SERVICES

VALUATION SERVICES

IN THIS ISSUE:

The Retail Real Estate Crisis

BY **BLANCHE ZELMANOVICH**

Since the beginning of the year, there have been a slew of retail bankruptcies, including Limited Stores (January), Wet Seal (February), BCBG Max Azria (February), General Wireless dba RadioShack (March), hhgregg (March) and Payless (April) to name a few. For at least several of these companies, this is not their first time at the bankruptcy rodeo. General Wireless is in what bankruptcy professionals affectionately call a "Chapter 22" (filing for Chapter 11 a second time) as the successor to RadioShack Corporation, which had previously filed in February 2015.

General Wireless is not the first retailer to file twice within a few years; just look at Sbarro which filed in April 2011 and March 2014, American Apparel which filed in October 2015 and November 2016, as well as Eastern Outfitters (the parent of discount chain Bob's Stores and the outdoor retailer Eastern Mountain Sports) which filed for a second time in February 2017 after acquiring Eastern Mountain Sports out of the Vestis Retail Group's April 2016 bankruptcy filing.

Landlords may feel they can find new tenants easily. Real estate is a limited commodity; if Barnes and Noble is closing stores, no worries, Amazon is opening them. However, the rate of store closures is not remotely close to that of new store openings.

The imbalance of stores opening to stores closing may be devastating to real estate developers and shopping mall operators. Fewer stores translate to reduced foot traffic at malls and shopping centers. This results in a domino effect. Less foot traffic means people spend less time at the mall, which in turn means less business for the smaller retailers. Do not be surprised if you start seeing major fast food and "fast casual" food vendors leaving the malls for a more neighborhood-friendly environment.

What Can Landlords Do Now?

You see the signs. Rent is not being paid timely, month after month, and the excuses start rolling in. Do you have another tenant waiting in the wings? If you do, great; out with the old and in with the new. However, that is not always the case and even less so these days. And the process may take a while and be costly.

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Landlords may want to consider negotiating with tenants. If the tenant has already filed for bankruptcy, you have remedies available to you. As a landlord you have the right to file a proof of claim with the bankruptcy court for losses in addition to unpaid rent. Was the lease assumed or rejected? What are your remedies? What are your responsibilities? The formulas can be complicated and the deadlines are short. This is when you want to bring professionals onboard who have the knowledge and knowhow to assist you with filing your claim.

What Can Tenants Do Now?

You see the signs. Cash flow has become a concern and it is becoming more of a challenge to make timely rent payments. Do you want out of your lease or if your lease is renegotiated, can you afford to stay? Talk to your landlord to explain the situation. See if something can be worked out. Maybe it is a short-term problem, or maybe the rent is a cost your business cannot sustain. Consider consulting with experienced professionals who can help you find cost savings and turn your business around.

Short-Term Trends

Just in case you are thinking this is the end of the retail filings for the year, it appears as though other retailers may follow suit shortly, including rue21, GameStop, bebe, Gymboree, Nine West and, of course, Sears. Even Macy's, with its flagship Herald Square location in New York City, is closing stores and reducing its footprint.

Given the competition from e-commerce, it is no surprise that investors remain cautious. Online retailing and innovations like same-day delivery, subscription boxes and "clicks to bricks" formats are disruptive factors.

A few trends can be anticipated:

Retail footprints will likely be smaller. Self-checkout kiosks are already old hat. "Smart" stores offer time-saving checkout features like the automated "virtual cart" that eliminates checkout counters and queues. Amazon's brick and mortar time saver, Amazon Go, lets shoppers simply walk in, grab items and walk out.

Temporary locations may be more popular. "Pop ups" can give retailers a chance to leverage social media hype while testing the market for creative concepts. Landlords will be happy to collect rent on vacant properties while showing off the space to potential longer-term tenants.

Bottom Line

Clearly the retail sector is facing an enormous challenge. Retailers and their landlords should factor the trends facing the industry into their decision-making, particularly when it comes time to renew leases. Consumer needs are changing, and traditional shopping center and mall tenants and landlords may need to be innovative with their in-store and online approach to meet new demands.

If sales are steadily declining, retailers may want to consider proactively working with a professional who is experienced with corporate recovery services. There may be solutions other than filing for bankruptcy that can help stabilize operations, address cash flow issues and manage vendor relationships.

For more information call or email Blanche Zelmanovich, CIRA Managing Director, CBIZ Corporate Recovery Services at 212.790.5879.

Tax Reform

Federal reform that affects the tax code is a high priority for both President Trump and Republicans in Congress. CBIZ National Tax Office's biweekly Tax Reform Tracker will monitor key trends in tax reform topics.

Infrastructure Consulting

Does your business include Infrastructure Projects costing $50M-$500M – as owner/developer, constructor, operator, service provider or financier? The CBIZ Infrastructure Advisory Group can provide comprehensive advice on capital structure and arranging, financial modeling, tax planning and incentives, insurance and risk management, public/private partnerships and other issues of relevance to these projects. Contact John Forry at 310.268.2000.

Upcoming Webinars

May 16
1-2 pm CST

The Business Case for Understanding Benefits and HR Trends

For companies with 50 to 1,000 employees.
Who should attend: HR professionals and C-suite executives.

May 24
1-2 pm CST

Unclaimed Property Best Practices to Prepare for Merger and Acquisition Transactions

Merger and acquisition activity is one of the most common triggers for abandoned and unclaimed property exposure.
Who should attend: CFOs, CEOs, Tax Directors, Tax Managers, Tax VPs, General Counsel.

Construction Companies May Be Missing a Critical Tax Opportunity

BY **RAJ RAJAN**

Lower wages in other parts of the world and improved communication technology have made it easier for construction companies to offshore many aspects of a design and build effort. The research and development (R&D) credit is one of the few incentives the government provides to help construction companies reduce the costs associated with paying employees in the U.S. to perform such activities.

Research and development activities may not immediately come to mind with the construction industry, but a number of day-to-day operations may qualify for the credit. The challenges of understanding how the credit functions and what qualifies for its use, however, have resulted in a number of construction industry companies missing out on taking advantage of this powerful tax credit reward.

History of R&D Credits

The R&D tax credit has been a part of the tax code since 1981 and provides an incentive for businesses to further their research and development efforts. Since then, a number of changes have been made to the credit, including which activities qualify, what costs can be included, how it is calculated and the manner in which any credits generated may be used. For example, the removal of the "discovery test" in 2003 expanded the credit to allow efforts that were new only to the company making the claim; efforts did not need to be innovative or new to the industry to qualify. New treasury regulations, IRS proclamations and judicial rulings provided additional guidance for time spent by business owners and executives on development efforts and the contract analysis necessary for inclusion of contractor costs.

In December 2015, Congress significantly enhanced the credit with the passage of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act). Changes in the PATH Act benefit small and mid-sized businesses by allowing business owners with businesses that have an average annual gross receipts amount for the prior three years under $50 million to use the R&D credit against their alternative minimum tax (AMT). The AMT had historically been a significant limitation for small business owners who wanted to use the credit.

The construction industry itself has seen significant changes over the last decade. New technologies, such as BIM modeling software, new material – both internally and on a structure's façade and LEED certification goals, give rise to opportunities for companies in the industry to benefit from the R&D tax credit.

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Costs able to potentially be included within an R&D credit claim include wages, supplies and outside contractors, as long as the costs incurred were for qualifying activities performed here in the United States. Qualifying activities for the credit involve meeting four basic requirements set forth by the tax code.

1. The activity must relate to a new or improved product or process that improves the component's function, performance, reliability and/or quality.
2. There must be uncertainty concerning the capability to develop, method of developing or appropriate design of a new or improved product or process at the outset of the project.
3. Substantially all of the activities must be elements of a process of experimentation to resolve the technical uncertainty.
4. The activity performed must fundamentally rely on principles of physical science, biological science, computer science and/or engineering.

Unfortunately, these requirements are vague, as they were written in a manner that allowed for application to all industries. It is only through regulations, court rulings and the audit process that there has been some level of clarification as to the applicability of the activities of a given industry.

Examples of Qualifying R&D Construction Activities

A number of activities performed every day by construction companies, particularly design and build companies, can meet the R&D tests. The following are examples:

- Determining optimal ventilation for a building design. Research and development activities are frequently involved, such as using dynamic energy modeling to structure airflow routing for increased efficiency and reduced energy consumption or modeling and analyzing wind tunnels to allow for the safe exhaust of vapors generated in a laboratory.
- Designing HVAC systems, in particular when improving efficiency, safety or reliability.
- Overcoming challenges associated with working with specific materials, such as undertaking a trial and error process to devise an optimal method of connecting various bronze railings without welding.
- Developing optimal storm water, wastewater and/or water flow systems. Examples include experimenting with reuse of water and/or minimization of water runoff through the use of site modeling.
- Experimenting with various types of materials in order to reduce energy consumption or related environmental concerns.
- Development efforts associated with means and method processes and/or improving equipment for lifting, transporting and/or installing an item of significant size or fragility.

How Construction Companies Take Advantage of R&D Credits

Just as important as the qualifying nature of the work is the agreement between the company performing the work and the client paying for the work. In order to qualify for the credit, the company making a claim must hold the economic risk of the development effort (i.e., are paid for success) and have substantial rights to the results of the development efforts. Ultimately, the government wants to reward the company who takes the economic risk of a development effort and can use the research results for future efforts.

Although the assessment generally must be made on a case-by-case basis, current case law has provided guidance to construction companies by identifying different types of contracts that have been found to qualify and not qualify. Specifically, fixed-price contracts have generally been found to provide the party performing the work the necessary economic risk of a construction effort to qualify for the credit. Time and Materials and Cost-Plus Agreements have generally been found not to confer upon the party performing the work the necessary economic risk to qualify. Additional language within the contract, such as warranty provisions, can help further clarify which party has the economic risk of successfully completing the effort.

Approach R&D Credits with Care

The IRS has identified the R&D credit as a significant area of improper claims and abuse. It made the credit a Tier 1 audit issue in the late 2000s and included the credit in both its 2016 and 2017 annual "Dirty Dozen" list of tax scams. Such actions by the IRS evidence the need for a proper assessment and documentation effort when supporting a claim. When calculated and documented properly, the credit can be a tremendous reward for the necessary day-to-day activities performed by the construction industry.

For more information about how to take advantage of the R&D claim, call or email Raj Rajan, Managing Director and Technical Lead for R&D Tax Credit Services, at 949.727.1327, or contact your local CBIZ MHM professional.

GUEST ARTICLE

Maximize the Value of Your Business

BY **DOUG HUBERT**

How much is your business worth and what can you do to increase the value of what you have built? Even if you are not planning to sell your business in the near future, there are several strategies that every business owner should employ to build a better company and create more value.

As part of this effort, it is important to understand that overall value is typically determined both as a function of your earnings and financial position and the inherent strength of your business (off balance sheet items). It is not uncommon to see two businesses with similar financial profiles bring in wildly different valuations due to these off balance sheet items. While it is easy to measure the value of your financial position, understanding and improving the off balance sheet items that create and drive value are critical to positioning your company for long-term success. To help strengthen your business, we offer seven core principles that we believe separate good businesses from industry leaders.

Build a Deep Management Team

One of the most difficult challenges for an entrepreneur, and one of the critical differences between a good company and a great company, is the depth and quality of the senior managerial team. Too many entrepreneurs make the mistake of trying to run and grow their businesses with only one or two people capable of making critical decisions. As a result, most businesses will plateau in their growth. If your company cannot function efficiently without your direct daily involvement, you need to immediately begin to hire and develop talent or the future of your business is in jeopardy. Jack Welch, the former CEO of General Electric, considered talent development and succession planning one of his greatest accomplishments in his tenure. Treat this issue with the same importance.

Diversify Your Customer Base

Your largest customer should ideally be no more than 15 to 20 percent of your revenue and profitability.

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While it is often efficient and easy to allow a major customer to develop into a substantial portion of your sales, nothing could be more dangerous to the future health and value of a business. Once a customer becomes a critical portion of your revenue or profits, then they own you. They can begin to dictate the financial terms of the relationship, and any change in their business – be it financial, personnel or otherwise – has a direct effect on the health and value of your business. While it might require extra effort and possibly some short-term sacrifices to your bottom line as you build other accounts, the long-term benefit of a diversified customer base is a significant reduction in your financial risk profile.

Maintain Quality Financial Information

A consistent area of weakness with most small and mid-sized companies is the lack of strong financial documentation. Most business owners do not want to spend the extra money to obtain an audit, believing a review or a compilation is just as good; it's not. Audited financials provide credibility with bankers, commercial financing sources, insurance companies and, most importantly, potential buyers. The extra money spent will be recovered in a higher premium when the business is eventually sold.

Develop a Proprietary Product or Service

To truly thrive as a company you must distinguish yourself in the marketplace by offering a unique product or level of service that cannot easily be replicated by competitors. While this seems obvious, very few companies are dedicated to creating this distinction. Ask yourself if your customers, employees and competitors can all quickly describe what differentiates your company. A superior product or service will create the opportunity for a pricing advantage in good times and customer loyalty in difficult periods.

Focus on Profitability

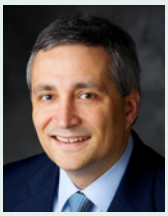
Too many business owners measure the success of their business on top-line revenue rather than pre-tax profitability. Value is created through maximizing profit, not maximizing revenue growth; a $25 million company earning $5 million pre-tax is worth more than a $40 million company earning $2 million pre-tax. Another common mistake is desire to limit profitability to limit taxes. While fast growing businesses often need the extra cash to fund growth, this approach loses money for business owners, as the focus becomes tax avoidance rather than operational efficiency and profit maximization. There are legal ways to minimize your taxes through use of an S-Corporation or LLC rather than a C-corporation.

Prepare and Execute a Business Plan

Establish operational and financial plans and goals for your business in one-, three- and five-year increments and share them with your employees. The plans should take into account various economic, industry and company-specific scenarios and how management would react to each. In addition to creating a roadmap for your future growth, this will focus your business and your employees on quantifiable goals and will allow you to make better business decisions as you grow your business.

Seek the Help of Outside Professional Advisors

Seek the assistance of outside professionals, especially a full-service accounting firm and law firm that can provide valuable advice as you grow your business. Not only can they provide objective counsel as you grow your business, they can help you avoid disastrous legal, financial and operational mistakes that may have significant financial consequences down the road. Similarly, if you plan to sell your business or are approached by a buyer, an investment banker can ensure you obtain the best possible transaction by restating your financials, preparing a memorandum that highlights the intrinsic value of your business (including off-balance sheet items) and quietly approaching other buyers to ensure a competitive process.



Doug Hubert, Managing Partner De NES Partners, LLC, has represented business owners and entrepreneurs across the United States in M&A transactions for over 25 years. Mr. Hubert is a registered representative of Securities Products and Investment Banking Services offered through, BA Securities, LLC.

How Will Artificial Intelligence Forever Change the Working World?

This article first appeared in the April BISNOW Real Estate Newsletter in several markets nationwide.

Whether you consider Artificial Intelligence (A.I.) the existential threat that will end the world, the innovation promising the greatest increases in human prosperity or something in between, it is difficult to argue that the impact of this technology on commercial real estate (CRE) and the broader economy will be insignificant.

Meet Your New Agent, Art. E. Fishell

Currently, electronic devices collect and store a lot of data with untapped potential. "Deep learning," or the ability to learn without being explicitly programmed, allows them to leverage that information, revolutionizing CRE. The sector is a document-intensive one. Virtual piles of data have accumulated, now residing in remote data centers when before they filled filing cabinets. Mining the mountains of lease agreements, transaction histories and financial statements has previously proven too expensive to justify allocating the human and monetary capital required. An A.I. system, however, can comb through these quickly, yielding valuable findings.

Buyers find the capabilities of A.I.-powered search engines so great that they depend on brokers' expertise less early in the process. A recently launched tool called CityBldr promises to do for CRE what Zillow did for residential, achieving in seconds what it takes land acquisition teams months to accomplish, according to Everyhome CEO Bryan Copley. The Seattle-based startup's product uses A.I. to find deals and estimate their return on investment, ranking land assemblages and properties based on their development potential. Brokers, on the other hand, are finding that A.I. lets them spend more time onsite with a client. Their consulting roles have been facilitated by increasingly sophisticated chatbots that can address the more menial tasks of booking appointments and responding to prospective buyers' and tenants' inquiries.

Other things to watch for include marketing campaigns tailored to individuals in ways that border on privacy infringements. Real estate portals may implement dating site algorithms to unite people with the physical space best suited to their needs and preferences. Sophisticated and accurate image categorization continues to be a boon to an industry so heavily reliant on pictures. As computers achieve artificial general intelligence, leads will become increasingly focused and data-informed, combining property availability with a buyer's tendencies, income and feature preferences, for example.

Economy – Jobs Eliminated and Responsibilities Changed

As millions of workers, especially less skilled laborers, find themselves replaced by more efficient, less expensive and less error prone machines, many economists are predicting a huge spike in unemployment. A.I. Oxford University researchers Carl Benedikt Frey and Michael A. Osborne quantify this danger, asserting that 47 percent of total U.S. employment will be at risk in the next 10 to 20 years.

Bill Gates, Stephen Hawking and Elon Musk have all expressed apprehension at the prospect of a world in which machines can perform most tasks better than humans and have implored the scientific community and governments to check the progress of this potentially catastrophic technology. Lawmakers, wary that a

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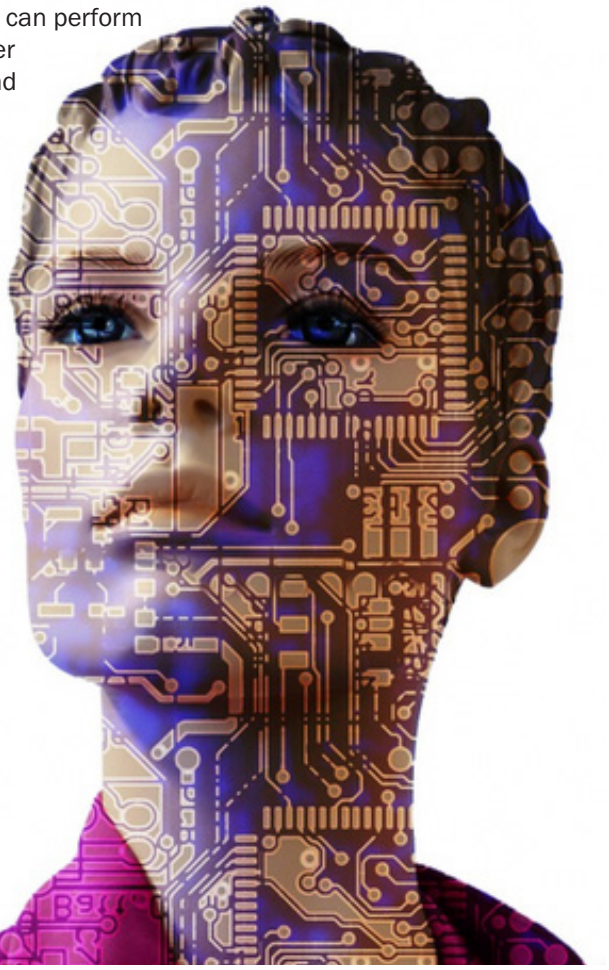

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tech-sated business landscape could take a while to adjust to accommodate those left jobless by A.I., are exploring educational programs fit to this digital era.

Optimists believe that with machines taking care of mundane tasks humans will be free to pursue more creative vocations. Many hope that the economy's trajectory will follow technology's exponential one, accelerated by A.I.

We may be approaching a time when machines will be able to outperform humans at almost any routine or analytical task, but property buying and selling contains an emotional element not solved solely by data analysis – at least, not yet.

The Human Element – What Machines Cannot Do

We have successfully programmed supercomputers to tackle a complex series of equations in fractions of seconds, a task that would take the most brilliant mathematician hours. We have had far less success imbuing devices with capacities that toddlers possess, the ability to correctly recognize a sketch of a cat, for example, which represents elementary symbolic reasoning.

Artificial Narrow Intelligence (ANI) comprises the vast majority of A.I. in the systems and applications we interact with each day. This software specializes; it does one well-defined thing extremely well. Thus, the jobs that are safest from obsolescence are those that require broad, abstract thought.

The CBIZ Commercial Real Estate National Practice works strategically with property developers, owners, investors and managers to capitalize on the value of data to support tactical and operational decisions that minimize risk and maximize property/ portfolio value.

EB-5 Changes Debated in April

BY **JOHN FORRY**

News reports at the beginning of May indicate that, as part of Congress' pending budget agreement through September 30, 2017, the EB-5 program is being extended through that date without change. However, changes continue to be debated.

As reported in our February 2017 issue, a draft bill by United States Citizenship and Immigration Services (USCIS) would increase the minimum investment from $500,000 to $1.35 million for projects in areas with high unemployment and from $1 million to $1.8 million for projects in areas with average or low unemployment. In addition, to qualify for the low-unemployment limit, a project would have to be located in a census tract or contiguous census tracts with a weighted average of 150 percent of the national unemployment average.

Certain Senators have called for the program to be repealed, but the Trump administration has been focused on creating U.S. jobs. To quote a recent report by the U.S. Department of Commerce – covering just fiscal 2012 and 2013 – "more than 11,000 immigrant investors provided $5.8 billion in capital, roughly 35 percent of the total investment ($16.7 billion), for 562 EB-5 related projects that ....were expected to create an estimated 174,039 jobs."

The U.S. is not the only country offering investors visa status in return for significant investments. However, several professionals involved in EB-5 financings have indicated that proposed changes such as those USCIS has proposed would not deter foreign investors looking to migrate to the U.S., which offers a strong capitalist democracy with good higher education programs for investors' families.

This report provided by John Forry, Managing Director, CBIZ MHM Los Angeles. John will continue to report on EB-5 developments in future issues. Should you have questions or comments, please contact your local CBIZ MHM professional.