FEBRUARY 2019 | ISSUE NO. 14

CBIZ Commercial Real Estate

QUARTERLY HOT TOPICS

Reduce Taxes. Maximize Cash Flow. Minimize Risk.

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.

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Commercial Real Estate Headed for a Slow Down

CBIZ CRE EDITORIAL STAFF

The improving economic conditions have created a near perfect environment for real estate over the past five years. Data collected by industry analyst IBISWorld shows that the commercial real estate sector grew at an annualized rate of 3.2% from 2013 to 2018. Industry operators also increased during that time by an annualized rate of 2%, and real estate employment rates recovered from the last economic recession.

Moving forward, the big story for the sector will be the impact of the federal interest rate increases. Interest rate hikes in 2018 slowed the sector's growth pattern, but indicators suggest that strong performances in other key industry subsets will keep the sector on an upward growth trajectory through 2023. Below, we take a closer look at these primary economic predictors and their implications for the sector.

Private Nonresidential Construction and Consumer Spending

Private nonresidential construction values increased by annualized rate of 2.8% from 2013 to 2018. Values are projected to rise through 2023. Strong nonresidential construction values bring benefits for real estate broker commissions, which then affect other related real estate services in the sector.

Consumer Spending

Consumer spending is a strong predictor of economic strength, and it increased by an annualized rate of 2.9% from 2013 to 2018. It is projected to continue increasing, which will

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likely create more demand for corporate expansion and business development activity.

Vacancy Rates

Vacancies in rental space are an indicator that there is an oversupply of nonresidential property in the market. From 2013 to 2018, office rental space vacancy rate declined by an annualized rate of 2.9%, which opens the door for potential new office space development in the coming years. Other types of commercial real estate are also seeing slight declines in vacancy rates, including retail and industrial spaces. Declines in vacancy rates are closely tied to the nationwide unemployment rate, which remains low and bodes well for future nonresidential property development.

10-Year Treasury Note Yields

The yield on 10-Year Treasury notes has a significant impact on commercial real estate entities. Credit is highly utilized in commercial real estate development, both to cover the cost of purchasing property and the cost of constructing new buildings. The increasing federal interest rate has made debt (and subsequently borrowing and lending) more expensive.

Commercial real estate felt the chilling effects of the four interest rate increases in 2018; growth declined by a projected 0.4%, leading to a loss of up to $1.1 trillion in industry revenue. As the economy slows, the Fed may forego interest rate increases in 2019; otherwise, the sector could continue to be negatively affected.

Corporate Profit

When companies have more profit and cash reserves at their disposal, they have a higher likelihood of investing in expansion projects, such as opening new locations or investing in property. Corporate profits did not follow a steady pattern over the past five years. Many companies had pared down their operations following the economic recession, and their lean operations helped to recover their cash reserves. But other macro events, including the decrease in crude oil prices and the appreciation of the U.S. dollar, led to corporate profit declines in 2015 and 2016.

It appears that corporate profits may be on an upward trend now. Perhaps fueled in part by the corporate tax cut in the 2017 tax reform law, corporate profits increased in 2018 and profits are expected to stay strong over the next several years.

Wages

Wages now take up a larger share of total industry revenues than they did in 2013. In 2018, wages accounted for approximately 14.6% of total industry revenue compared to 13.7% in 2013, according to IBISWorld data.

Podcasts, Webinars & Resources

Podcasts and Webinars

Key Elements of a Solid Insurance Strategy
Lisa Winchester, a Vice President of CBIZ Insurance Services, Inc. in the Mid-Atlantic region, discusses key elements of a solid insurance plan.

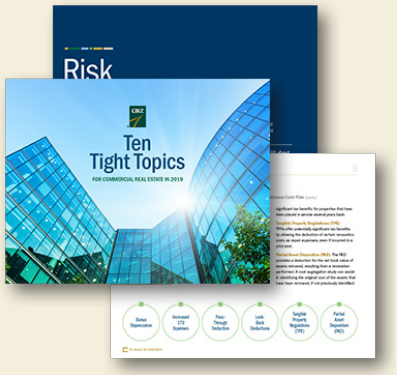
Understanding Group Captives
Mark Stoltz, Regional President Texas – PC Texas, discusses group captives.

Upcoming live webinars and events can be found here.

CBIZ Employee Benefits On-Demand Webinars, available 24/7, can be found here. Popular titles:

Recently Published Resources

- Guide to the New Tax Law
- Regulatory & Legislative Update: What Employers Need to Know in 2019
- Employee Benefits Benchmark Report
- CRE eBook: Ten Tight Topics



It is expected that wages will continue to take up a larger share of total industry revenues moving forward.

Technology Trends

Profit margins in some subsectors of the industry have also been negatively affected by new technology. New property appraisal databases offer automated valuation models, which reduces the demand for real estate appraisers. More websites are offering free real estate listing services, which affects the demand for brokerage firms and leasing and rental companies. These subsectors will need to adapt their service model to reflect the changes in technology and the availability of new data aggregation tools in the marketplace.

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Multi-family Housing Development

Young adults are not buying homes with the same frequency as they did in years past, which fuels demand for apartment and other multi-family housing developments. The trend toward apartment living among the 20- to 34-year-old market is expected to increase nationwide in the coming years.

2019 and Beyond Outlook

Real estate values are expected to rise over the next five years, which will benefit real estate developers and related consultants. Continued increases in consumer spending will lead to more demand for retail space and other commercial activity and distribution centers. Growth areas are expected to counteract the potential negative effects of the interest rate and wage cost increases and technology trends, but the competing factors will make for a slower rate of growth for commercial real estate during the next five-year cycle. IBISWorld projects a 0.3% annualized growth over the next five years.

Your Team - For More Information

For more information about how commercial real estate trends will affect your business, don't hesitate to connect with your CBIZ advisor or a member of our contact a member of our team.

Real Estate Investment: Tips for Navigating a Bankruptcy Real Estate Sale Process

By **JEFFREY T. VARSALONE**

As has been well publicized, several retail businesses have recently filed Chapter 11 bankruptcies only to fail to reorganize and be forced to shut down operations and liquidate. Toys R Us is one of the more high-profile failed reorganizations, and Sears, as of the date of this article, is barely escaping liquidation. There are plenty of examples, as this listing shows. When forced to liquidate, a retail debtor company's real estate portfolio is often the most significant non-operating asset that will be sold to pay creditors. Opportunities for real estate value investors abound, but prospective buyers must be aware of nuances specific to bankruptcy sales in pursuing such potential deals. Below are some highlights of what to expect as you mine for value.

Expedited Timeline

Under most circumstances, the debtor company will remain in control of the sale of its assets, with the sale of the real estate taking place on an expedited timeline to mitigate the administrative costs of the liquidation and maximize recovery for the debtor's creditors.

Buyers should be aware that they will have to move quickly and make the opportunity a top priority. The entire process, from receiving an initial executive

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summary through the due diligence process and submitting a binding "qualified" bid, could be on a court-mandated timeline that is 90 days or less. There must be immediate and intense focus on the diligence process and making a capitalization rate and value determination. Requests for extensions of time for investors to do further work are rarely granted.

Highest and Best

Unlike foreclosure sales or sales by a receiver appointed under state law, most bankruptcy sales are not privately negotiated transactions nor open bids subject only to the approval of a bank or other secured creditor. Rather, the debtor company has a duty to produce the "highest and best" bid, meaning that most times bankruptcy sales are a competitive process. Most court-approved sale procedures provide that any bid must meet a minimum threshold in order to be a qualified bid. In the event that multiple qualified bids are received, qualified bidders are then advanced to an auction process. At auction, the highest bid submitted is the opening bid, and bidding rounds then take place, with court-approved minimum bidding increments. Bidding continues until there is a winner, which most of the time is the highest bid, although in certain circumstances non-monetary considerations can lead to a bid that is not necessarily the highest in dollar amount being designated as the highest and best bid.

In preparing for the auction, buyers should make sure they have demonstrated the financial wherewithal to close a transaction at the highest amount they plan to bid to avoid a situation where a buyer's highest bid is not accepted as highest and best due to the appearance of closing risk.

Stalking Horse Opportunity

One benefit to prioritizing the opportunity and making a very quick decision to submit a binding bid is the potential opportunity to serve as a "stalking horse" in the sale process. Since bankruptcy courts appreciate the certainty of locking in a "floor" bid in an auction process, courts will often approve a "breakup" fee and expense reimbursement for a stalking horse bidder in an amount generally around 3% of the total purchase price. While there are no assurances that a stalking horse bidder will ultimately be the winning bidder, for the aggressive buyer willing to commit early, the breakup fee and expense reimbursement ensure at least a consolation prize.

Free and Clear and Credit Bidding

One of benefits of buying real estate pursuant to a bankruptcy sale is that property is conveyed free and clear of any liens, claims and encumbrances. That means that regardless of the amount of the purchase price, a bank's lien, a judgment lien and other recorded liens are washed out in the transfer.

Buyers should note that per a 2012 Supreme Court ruling, a secured creditor may "credit bid" up to the full amount of the claim when a Chapter 11 debtor elects to sell its assets lien-free. To account for this, buyers need to determine whether they are willing to pay more than the total amount of the secured debt encumbering the property. Buyers should also inquire as to whether secured creditor(s) want to gain possession of the property through a credit bid and whether such secured creditor(s) would be willing to designate an acceptable cash price that is less than the full amount of the debt in exchange for a waiver of credit bid rights.

The Sale Hearing and Sale Order

Buyers should be aware that submitting the highest and best bid does not automatically mean that you are the winning bidder and can proceed to closing the transaction. The bankruptcy court must first approve the sale, which is subject to objections by other parties-in-interest. The court will conduct a sale hearing at which the court must determine, among other things, that the sale is in good faith, that the sale process was free of collusion, and that approval of the sale is in the best interests of the debtor's estate and its creditors.

If the court approves the sale, it will enter a sale order. For buyers, it is important that the sale order contain all customary and case-specific findings and binding paragraphs. Specifically, buyers should ensure that the sale order clearly relieves the buyer from any successor liability, other than certain liabilities that "run with the land" and cannot be extinguished by the sale order, such as environmental liabilities. Once the sale order is entered by the court, the closing should proceed much like closings outside of bankruptcy except that it will likely be on an expedited timeline and the forum of the bankruptcy court remains in the background to resolve any disputes that arise, if needed.

Bottom Line

Failed retail Chapter 11 bankruptcies present opportunities for real estate investors. As retail bankruptcies will continue in 2019, there are likely to be plenty of opportunities for real estate investors looking for value plays. As a trusted advisor, CBIZ stands ready to help provide the right focus and guidance to execute on such opportunities. Happy hunting!

Your Team – For More Information

Jeff Varsalone is a Managing Director in CBIZ's Corporate Recovery Services Group. Don't hesitate to reach out to Jeff (jvarsalone@cbiz.com or 212.790.5876) on this topic and other special situations transactional issues.

Looking to Invest in Qualified Opportunity Zones?

Adapted from Bisnow National CRE News, 12/9/2018

As investors across the nation seek to deploy billions of dollars in capital gains into Qualified Opportunity Zones (QOZs), they are actively seeking guidance about the program and on the hunt for resources to help identify neighborhoods, assets and available land within opportunity zones most ripe for investment.

The program, created through the passing of the Tax Cuts and Jobs Act, aims to incentivize private investment in underserved and otherwise blighted communities across the U.S. in exchange for a hefty tax break. More than 8,700 census tracts have been classified as opportunity zones, and numerous opportunity zone funds have already launched to take advantage of the program – with an estimated $6 trillion in unrealized capital gains eligible to be deployed into opportunity zones, according to a study conducted by Real Capital Analytics.

In response to high demand from firms and high net worth individuals interested in the QOZ program, a number of tools have come to market to help potential investors understand how the program works, identify neighborhoods that qualify for it and locate assets within the designated areas in need of investment.

"Opportunity zones have brought national attention to areas of the country that have been too often looked over for investment. Unlike traditional community development institutions, knowledge and understanding about these communities is quite limited," Smart Growth America's Vice President of Land Use and Development Christopher Coes told Bisnow. Coes is also director of national real estate developer and investor network LOCUS.

"The structure of the opportunity zones tax incentive places the onus on the investor to identify and conduct due diligence which requires an understanding of not only the project but also the place. Because of this demand, we're seeing a lot of tools [come to market] to help assist investors and policymakers."

The list of designated QOZs in which a Fund may invest to meet its investment requirements can be found at IRS Notice 2018-48.

Additional Resources

List of Qualified Opportunity Zones (IRS Notice 2018-48)

Additionally, Bisnow provided resource sites in its December 9 newsletter, including:

- Qualified Opportunity Zone Resource Center For Real Estate Developers – a St. Petersburg, Florida-based real estate data and analysis company
- Economic Innovation Center Opportunity Zones Resources – an economic public policy organization
- Reonomy Opportunity Zone Search Tools – a New York-based real estate data provider
- Enterprise Community Partners' Opportunity360 – a nonprofit that works with affordable housing
- Novogradac's Opportunity Zone Mapping Tool – a professional services provider
- Smart Growth America-LOCUS Opportunity Zones Navigator – a national network of real estate

Related Reading

- Your Qualified Opportunity Zone Questions Answered
- How Qualified Opportunity Zones May Help Real Estate Developers & Investors Circumvent Capital Gains Tax

Real Estate Partnerships and the Looming Tax Shelter Threat

By **CHRISTOPHER HANEWALD**

Many touted the tax reform legislation known as the TCJA as the most significant change to the Internal Revenue Code (IRC) since the Tax Reform Act of 1986. While those reactions are most assuredly true, the proclamations were made at a time when there was substantial uncertainty about the application and applicability of a number of new and revised IRC sections.

In the roughly 14 months since the passage of the TCJA, taxpayers have been eager to capitalize on the aforementioned tax cuts. The changes have left tax practitioners attempting to keep pace while trying to decipher hundreds of pages of proposed and final tax regulations. Certain gray areas have been clarified by subsequent regulations, sometimes at the expense of taxpayers' nefarious intentions, but other aspects of the new law have only become more confusing as regulations are issued and practitioners begin applying these provisions for the first time in the 2018 filing season.

Business Interest Changes under the Tax Reform Law

Perhaps the area most exemplary of such confusion concerns the newly imposed limit on the deductibility of business interest. The TCJA limits the interest expense deduction for any business to its interest income plus 30% of its adjusted taxable income (roughly equating to EBITDA for tax years prior to 2022 and EBIT thereafter).

The application of the new limitation imposed on the deductibility of business interest under Section 163(j) applies to all business entities; however, there are two important exemptions from the application of this

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limitation, which taxpayers and their practitioners will be focusing on in the coming months.

First, if a business has average gross receipts for the prior three years of less than $25 million, that business is exempt from the limitation *unless that entity is considered a tax shelter* (Small Business Taxpayer Exemption). Second, any entity that qualifies as a real property trade or business (RPTB) has the ability to elect out of the interest limitation in exchange for a slower depreciation schedule on real property.

While the preceding exemptions are not exhaustive, those two alternatives will assuredly be the most highly utilized by taxpayers, particularly in the real estate sector, seeking to avoid any potential limit on the deductibility of their business interest. The release of 400-plus pages of proposed regulations concerning Section 163(j) in November 2018 brought little clarity and, in fact, has stoked a realization among practitioners that unintended consequences loom at every turn. In particular, how a "tax shelter" is defined has renewed importance for tax practitioners for the first time since the 1980s.

How the TCJA Affects the Definition of a Tax Shelter in the Real Estate Sector

The tax shelter caveat to the Small Business Taxpayer Exemption has garnered significant scrutiny in the wake of the proposed Section 163(j) regulations. A tax shelter, as cumulatively defined by IRC Sections 448, 1256 and 461, is any partnership or entity, other than a C corporation, that has more than 35% of losses in a tax year allocable to limited partners or limited entrepreneurs. A limited entrepreneur is considered any business owner who is not actively engaged in the operations or management of the business.

Thus, if we consider a routine example of a real estate partnership with four partners and only one of those partners manages day-to-day operations, an issue immediately arises. Assuming this partnership has a standard no-frills operating agreement, 75% of the profits and/or losses will be allocated to limited entrepreneurs according to the definition above. If the partnership keeps with operations of an average real estate partnership, it would operate at a loss in its early years.

Suddenly, that partnership operating a few single-family rentals made possible through debt financing will be faced with an expensive and irrevocable decision. Either:

a. Elect to be an RPTB and accept a costly and irrevocable depreciation result for assets placed in service prior to 2018; or
b. Accept the limitation of business interest because their investment has abruptly become a tax shelter.

Unfortunately, neither option presented is particularly palatable for a small business that may be squeezed for returns. Moreover, while a limitation of interest in one year is not permanently lost, partnerships holding assets for long-term investment will not recognize the timing difference for years until an ultimate disposition of the asset or partnership interest occurs.

Careful Analysis Required!

As the simple example above demonstrates, no single change stemming from the TCJA is occurring in a vacuum. These new or altered provisions are interacting with existing frameworks within the IRC to ensure that compliance is neither black nor white. This filing season it will be imperative for practitioners to communicate loudly and clearly with clients as difficult and potentially irreversible decisions must be contemplated.

Your Team – For More Information

For more information about this topic and related issues, don't hesitate to contact Christopher Hanewald (901.685.5575) or your local CBIZ MHM tax professional.