

# JOURNAL OF ACCOUNTANCY

TAX

## Harvesting Tax Benefits of Green Building Incentives

### Energy-efficiency credits and deductions are sprinkled throughout the Code.

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In the past two years, several federal tax incentives have been extended and enhanced for designing and constructing energy-efficient buildings, both residential and commercial. Some of these measures should be equally attractive for businesses and individuals looking to remodel existing homes and workplaces to save on energy and, as a bonus, taxes.

Four federal laws enacted since early 2008 contain provisions targeting energy conservation: the Economic Stimulus Act of 2008, PL 110-185 (ESA); the Housing Assistance Tax Act of 2008, PL 110-289 (HATA); the Emergency Economic Stabilization Act of 2008, PL 110-343 (EESA); and the American Recovery and Reinvestment Act of 2009, PL 111-5 (ARRA)

In addition, many states and local governments have enacted provisions to encourage energy-efficient buildings.

Too often, a flurry of legislative activity can overwhelm taxpayers and their advisers with new provisions. Typically, the taxing authorities need time to develop summaries and guidelines for newly enacted laws. As a result, taxpayers who could benefit from the deductions and credits might not be aware of them, in some cases missing out on substantial savings. Here are five recent federal provisions expanded or extended by the EESA and the ARRA that should be of interest to builders, architects and anyone in the market for a new building or thinking about retrofitting one for energy savings. These are by no means all the tax incentives for energy-efficient building or remodeling even in these two acts. The EESA extended a number of provisions of the landmark Energy Policy Act of 2005. Among the ESA's provisions were those providing for 50% bonus depreciation on equipment and more funding for the low-income home energy assistance program. HATA requires states to consider energy efficiency in low-income housing when allocating available tax credits to those projects.

#### **ENERGY-EFFICIENT COMMERCIAL BUILDING DEDUCTION**

For commercial buildings, IRC § 179D provides a deduction of up to \$1.80 per square foot for energy-efficient features of the building's construction or retrofit. The taxpayer must secure an analysis by a qualified person (defined as a professional engineer or contractor licensed in the jurisdiction where the real estate is located) who must use software prescribed by the IRS. This deduction is effectively an acceleration of depreciation deductions that would have otherwise been spread over a 39-year recovery life, and reduces tax basis accordingly.

This incentive was originally enacted as part of the Energy Tax Policy Act of 2005 (PL 109-58), but was largely overlooked by tax advisers because of its original expiration date of Dec. 31, 2007, for buildings placed in service after Dec. 31, 2005. It was extended an additional year by the Tax Relief and Health Care Act of 2006 (PL 109-432) and then until the end of 2013 by the EESA. Qualifying commercial buildings can include multifamily residential structures so long as they have more than three stories above grade.

Three primary building components are analyzed to determine the qualifying credit, with each available for a deduction of 60 cents per square foot:

- Interior lighting systems
- HVAC (heating, ventilation and air conditioning) systems
- Building envelope (defined as the outer shell used to protect the indoor environment as well as to facilitate its climate control)

In each case, the analysis considers the extent to which the construction of the building provides energy consumption reductions from the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE) 90.1-2001 baseline (as in effect April 2, 2003), which is a widely used industry standard. Since the majority of states' standard building codes are based on the subsequently developed ASHRAE 90.1-2004 or later iterations, virtually all buildings in these states will qualify for some or all of the deduction, even if built to only the minimum standards. Engineers use a modeling guideline promulgated by the U.S. Department of Energy. The study, which must include a signed certification, is not attached to the taxpayer's return but is instead maintained in the taxpayer's file for future documentation in case of an IRS inquiry or examination.

An interesting application of this benefit occurs when the building is owned by a government, school or municipality. Since Congress' intent was to encourage energy-conscious construction, and many energy-efficient buildings across the country are owned by government agencies (which of course do not pay taxes), there was concern that the impact of the incentive would be dramatically reduced since it was not useful for these properties. To address this concern, Congress made the unusual decision to allow the building designer (typically the architect) to take the deduction, even though the designer has no ownership interest in the property. In this case, the deduction is particularly valuable, since no basis reduction is required. The building owner must approve the choice of the designer in writing.

The IRS has released further guidance in notices 2006-52 and 2008-40. The ARRA increased the carryback of net operating losses to up to five years for certain small businesses, so this deduction could provide an immediate cash benefit even if the current economic downturn has reduced or eliminated profitability in the current tax year.

#### **NEW ENERGY-EFFICIENT HOME CREDIT**

Although this incentive is scheduled to sunset at the end of this year, IRC § 45L has since August 2005 allowed eligible contractors that construct new energy-efficient homes to claim a federal tax credit of \$2,000 for each new home they sell. A qualified energy-efficient home is one that is certified to consume at least 50% less energy for heating and cooling than that of a comparable home constructed in accordance with the standards of section 404 of the 2004 Supplement to the 2003 International Energy Conservation Code (2004 Supplement), and to have building envelope component improvements that provide for a level of heating and cooling energy consumption that is at least 10% below that of a comparable home. In addition to meeting these requirements, manufactured homes must also meet the Federal Manufactured Home Construction and Safety Standards (24 CFR part 3280). A reduced credit of \$1,000 is also available for manufactured homes that meet certain lower standards.

The intent is to encourage builders to invest more in these efficiencies by allowing them to offset some or all of the cost through the credit. Since the credit is per qualifying home, this can add up to a sizable tax benefit. In addition, of course, homeowners will realize monthly savings on energy bills, and probably higher home values, as a result of these enhancements to the property.

As with the section 179D deduction, the certification is made by a licensed professional engineer or a contractor who is unrelated to the homebuilder or manufacturer. Many homebuilders who build in accordance with Leadership in Energy and Environmental Design (LEED) standards will qualify for this credit, and others who might not qualify could do so with relatively minor construction changes. LEED was developed by the U.S. Green Building Council for rating a building's site design, water and energy conservation, use of environmentally friendly materials and other criteria. The certification must come from an individual certified by the Residential Energy Services Network (or an equivalent rating network) to conduct these studies, using software approved by the IRS for this purpose. As with the section 179D deduction outlined above, this certification is not attached to the tax return but is maintained in the taxpayer's files in case the IRS conducts an inquiry or examination.

These provisions are outlined in IRC § 45L, and further guidance is provided in IRS Notice 2006-27. The credit coordinates with the other components of the general business tax credit under section 38 and reduces the taxpayer's basis in the building. Unused current-year credits may be carried back one year or forward up to 20 years. Although this credit is set to sunset at the end of this year, others were extended through 2010 and in some cases expanded by the ARRA. Among these is the section 25C residential building improvement credit available to homeowners.

### SECTION 25C RESIDENTIAL HOME IMPROVEMENT CREDIT

For 2009 and 2010, this credit is expanded from 10% to 30% of qualifying improvements, with a lifetime cap per taxpayer of \$1,500. Prior credits claimed under similar rules in effect before 2009 do not reduce this credit.

Qualifying improvements include installing insulation materials, exterior windows (including skylights), exterior doors, central air conditioners, natural gas, propane or oil water heaters or furnaces, hot water boilers, electric heat pump water heaters, certain metal roofs and stoves, and advanced main air circulating fans. These improvements qualify only if made to existing homes. The improvements must meet certain efficiency guidelines published by the IRS (see especially an interim guidance update, Notice 2009-53, issued June 1, 2009), and the vendor will typically be able to determine if an item qualifies.

### SECTION 25D RESIDENTIAL CREDIT FOR CERTAIN ENERGY-EFFICIENT ITEMS

Another ARRA amendment allows increased credits for installing state-of-the-art energy-efficient systems in new or existing homes through 2016. A 30% tax credit is available for geothermal heat pumps, solar panels, solar water heaters, small wind energy systems and fuel cells (IRC § 25D). The credit applies to the cost of labor and installation as well as the cost of the equipment. Except for fuel cell credits, which qualify only if made to an existing principal residence, these credits are also available for improvements to rental properties and second homes. There is no cap on the amount of credit that can be claimed. IRS Form 5695, *Residential Energy Efficient Property Credit*, has been developed to assist taxpayers with claiming this credit. See also interim guidance in Notice 2009-41, issued April 22, 2009.

### ACCELERATED DEPRECIATION FOR "SMART" ELECTRICAL SYSTEMS

The EESA amended the IRC § 168 MACRS (modified accelerated cost recovery system) provisions to assign a 10-year recovery period to qualified "smart" electric meters and grid systems (section 168(e)(3)(D)(iii) and (iv)). Otherwise, electrical transmission and distribution equipment and related land improvements generally are 20-year property. The property must have been placed in service after Oct. 3, 2008. The taxpayer realizing the enhanced depreciation, of course, is generally an electrical utility. But smart meters can benefit electric customers as well (see sidebar, "Smarter Electric Power," below).

On behalf of their clients, particularly those in construction trades, CPAs can review these federal provisions as well as state and local ones in their jurisdiction. Often, the local or state taxing authority will be helpful for gaining a full understanding of additional tax incentives, in addition to providing information regarding any loan or grant incentives that might be available.

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## Smarter Electric Power

Old-fashioned meters mechanically record and display cumulative kilowatt-hours. A smart meter, on the other hand, operates digitally and can communicate by digital radio signal to both the utility and the customer, showing electricity consumption over time. This information allows utilities to price power higher for peak usage time throughout the grid and lower for times of less demand. Potentially, customers can monitor and adjust their power use to save on their electric bills, while helping even out gridwide peaks and valleys of demand. More predictable power use should in theory yield lower rates as utilities rely more on their own generating capacity and less on buying power from each other. The smart meter also allows utilities to read meters remotely.

Likewise, a smart grid uses similar technology to increase the efficiency of energy flow through the system.

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## EXECUTIVE SUMMARY

- **In the past two years**, several federal tax incentives have been extended and expanded for designing and constructing or remodeling energy-efficient buildings, both residential and commercial.
- **A deduction of up to \$1.80 per square foot** is available through 2013 for certain energyefficient features in a commercial building construction or retrofit.
- **Homebuilders may claim** a credit of \$2,000 per certified energy-efficient home they build. This section 45L credit sunsets this year.

■ **The section 25C residential home** improvement credit for installing insulation, new windows and certain heating and cooling and other systems has been increased this year and next, as has the section 25D credit for state-of-the-art residential green energy systems such as solar and wind-generated power systems.

■ **The depreciation recovery period** for “smart” electrical meters and grid systems has been halved to 10 years.

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## AICPA RESOURCES

### JofA articles

- “[Tax Matters: Clean Energy Gets a Tax Jolt](#),” June 09, page 76
- “[Checklist: Be an ‘Energy Star,’](#)” March 09, page 34
- “[The Dollars and Cents of Green Accounting](#),” May 05, page 47

Use [journalofaccountancy.com](http://journalofaccountancy.com) to find past articles. In the search box, click “Open Advanced Search” and then search by title.

### Other article

“[Tax Incentives ‘Energized’ in 2009 Stimulus Package](#),” *AICPA Tax Insider*

### CPE

- *Kess on 2009 Tax Legislation: Economic Stimulus Act*, a CPE self-study course (#353360)
- *2009 Recovery Act: Provisions for Individuals*, a CPE self-study course (#153360)
- *2009 Recovery Act: Provisions for Businesses and Other Changes for 2009*, a CPE self-study course (#153361)

### Webcast

“The New Stimulus Act ... What You Need to Know” (#780175)

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### [The Tax Adviser and Tax Section](#)

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## OTHER RESOURCES

### Web sites

- Energy Star (U.S. Environmental Protection Agency and U.S. Department of Energy), [energystar.gov](http://energystar.gov)
- SmartMeters, [smartmeters.com](http://smartmeters.com)
- Database of State Incentives for Renewables & Efficiency, [dsireusa.org](http://dsireusa.org)

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