BURR FORMAN LLP

Tax-Advantaged Energy Efficient Retrofits May Decrease Operating Expense and Increase Gross Potential Rent

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Making your property more energy-efficient can help reduce operating costs and potentially increase the rent you can charge. Unfortunately, investments and improvements to commercial property generally must be capitalized and depreciated over the property's life, which is typically 27.5 years for residential rental property.

However, Section 179D of the Internal Revenue Code, as modified by the Inflation Reduction Act, offers a generous tax deduction for the year that energy-efficient property is placed in service: the deduction for qualified property that enters service on or after January 1, 2023, is equal to the lesser of the cost of the property entering service or the “savings per square foot.”

Savings per square foot are calculated as $0.50 per square foot for buildings with 25% energy savings plus $0.02 per square foot for each percentage point of energy savings above 25%, with a maximum deduction of $1.00 per square foot. If local prevailing wage and apprenticeship requirements are met, the maximum deduction may be increased by up to five times the savings per square foot amount.

There are two types of property that can qualify for the 179D deduction: “energy efficient commercial building property” and “energy efficient building retrofit property.” Energy-efficient commercial building property must be a depreciable or amortizable property that is installed on or in a building in the United States within the scope of a specified Reference Standard 90.1 of the

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American Society of Heating, Refrigerating, and Air Conditioning Engineers (ASHRAE) and the Illuminating Engineering Society of North America (i.e., commercial buildings and residential rental buildings that are at least four stories high) as part of (1) the interior lighting systems; (2) the heating, cooling, ventilation, and hot water systems; or (3) the building envelope, and must be part of a plan to reduce the annual energy and power costs by 25% or more compared to a comparable building meeting the requirements of Reference Standard 90.1.

Energy efficient building retrofit property (Retrofit Property) must also be a depreciable or amortizable property that is installed on or in a “qualified building” as part of (1) the interior lighting systems; (2) the heating, cooling, ventilation, and hot water systems; or (3) the building envelope pursuant to a “qualified retrofit plan.”

For purposes of Retrofit Property, a qualified building is any building in the United States that was originally placed into service at least five years before a qualified retrofit plan for that building was established, and a qualified retrofit plan must be written by a qualified professional and must specify the modifications to the qualified building which, in the aggregate, are expected to reduce the building’s energy use intensity by 25% or more in comparison to the baseline energy use intensity of that building.

All energy savings must be measured against the latest ASHRAE standard affirmed by the Secretary of the Treasury at least four years prior to the property being placed into service. This means that ASHARE Standard 90.1-2007 applies where construction began prior to January 1, 2023, or where the property is placed in service before January 1, 2027, and ASHARE Standard 90.1-2019 applies where construction began after December 31, 2022, or where the property is placed in service after December 31, 2026.

For more information about the local prevailing wage and apprenticeship requirements, please see the recent article by Burr & Forman attorneys Matthew Scully and John Wall.

The changes to Section 179D instituted by the Inflation Reduction Act dramatically expand the availability of the Section 179D deduction, making it more accessible and attractive to commercial property owners looking to save themselves and their tenants money by reducing energy consumption. While the current iteration of Section 179D does not have an expiration date, changes to the tax code (like death and taxes) are inevitable, and there is no time like the present to take advantage of the current rules.