

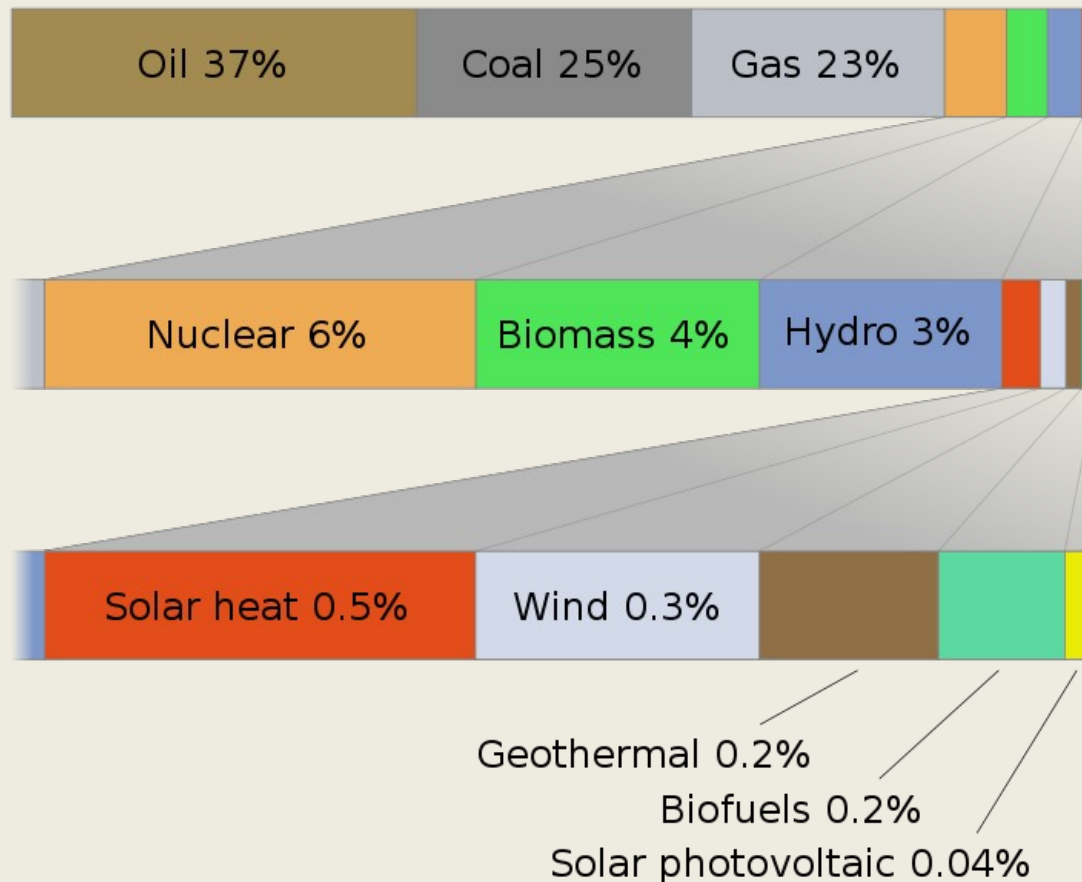
# Pocket Some Green While Going Green!!!

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# Introduction

- Taxing authorities at both the federal and state levels have been very busy over the past year or so as they draft legislation that is intended to encourage the efficient use of energy for construction in the United States.
- The Obama administration has made no secret of its desire to encourage such efficiencies by providing tax and other incentives, and many states have quickly followed suit.
- With the stakes set so high as they relate to our national dependence on foreign energy, this area seems ripe for continuing incentives, and many businesses are adopting policies that are designed to create energy efficient cultures within their organizations.
- Good for the earth, good for business, and getting an added tax benefit is a real bonus!

# World Energy Use



# Applicable Legislation

- Four pieces of federal legislation have been enacted since early 2008 which contain provisions targeted at energy conservation:
  3. The 2008 Economic Stimulus Act,
  4. The 2008 Housing Assistance Tax Act,
  5. The 2008 Emergency Economic Stabilization Act, otherwise known as the “Bailout Bill” (this Act extended various important provisions contained in the landmark Energy Policy Act of 2005), and
  6. The American Recovery and Economic Investment Act of 2009, also called the “Stimulus Bill.”

In addition, Kentucky’s 2008 legislature enacted House Bill II, which provides a variety of residential and commercial energy tax provisions.

# The Challenge

- A common challenge that often results from such a flurry of legislative activity is that taxpayers and advisors become overwhelmed and confused by all of the new provisions, and typically the taxing authorities need significant time to develop helpful summaries and guidelines relating to the newly-enacted laws. This means that possible deductions and credits can be overlooked, and in this case many of these are quite substantial.
- To help address this concern, the following summarizes the key incentives into five main categories:

# 1. Section 179D deduction for commercial real estate

- This incentive was originally enacted as part of the Energy Policy Act of 2005 (EPAct), but was largely overlooked by advisors because of its original expiration date of December 31, 2008. However, the 2008 Emergency Economic Stabilization Act, Bailout extended the provision so that it applies to commercial real estate construction and improvements, and residential rental properties with more than three stories, made after December 31, 2005 and through December 31, 2013. Section 179D provides a deduction of up to \$1.80 per square foot for energy efficiencies that are part of a building's construction or retro-fit. To claim the deduction, the taxpayer must secure an analysis that is made 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 IRS. This deduction is effectively an acceleration of depreciation deductions that would have otherwise been claimed over a 39 year recovery life, and reduces tax basis accordingly. Three primary building components are analyzed to determine the qualifying credit, with each available for a \$.60 per square foot deduction:
  - Interior lighting systems
  - HVAC systems
  - Building envelope (defined as the outer shell used to protect the indoor environment as well as to facilitate its climate control)

# 1. Section 179D deduction for real estate, continued

- In each case, the analysis considers the extent to which the construction of the building provides energy consumption reductions from a ASHRAE 90.1-2001 (American Society of Heating, Refrigerating and Air-Conditioning Engineers) baseline, which is a widely-used industry standard. Since the majority of states' standard building codes are based on ASHRAE 90.1-2004 or later, virtually all buildings in these states will qualify for some or all of the deduction even if built to only the minimum standards. Engineers will 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 tax), there was concern that the impact of the incentive would be dramatically reduced by eliminating 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 designer in writing.
- These provisions were originally enacted as Section 1331 of the EPA Act, and codified into IRS Code Section 179D. IRS has released further guidance under IRS Notices 2006-5 and 2008-40. Recent legislation increased the carry back of net operating losses to up to five years, so this deduction could provide for an immediate cash benefit even if the current economic downturn has reduced or eliminated profitability in the current tax year.

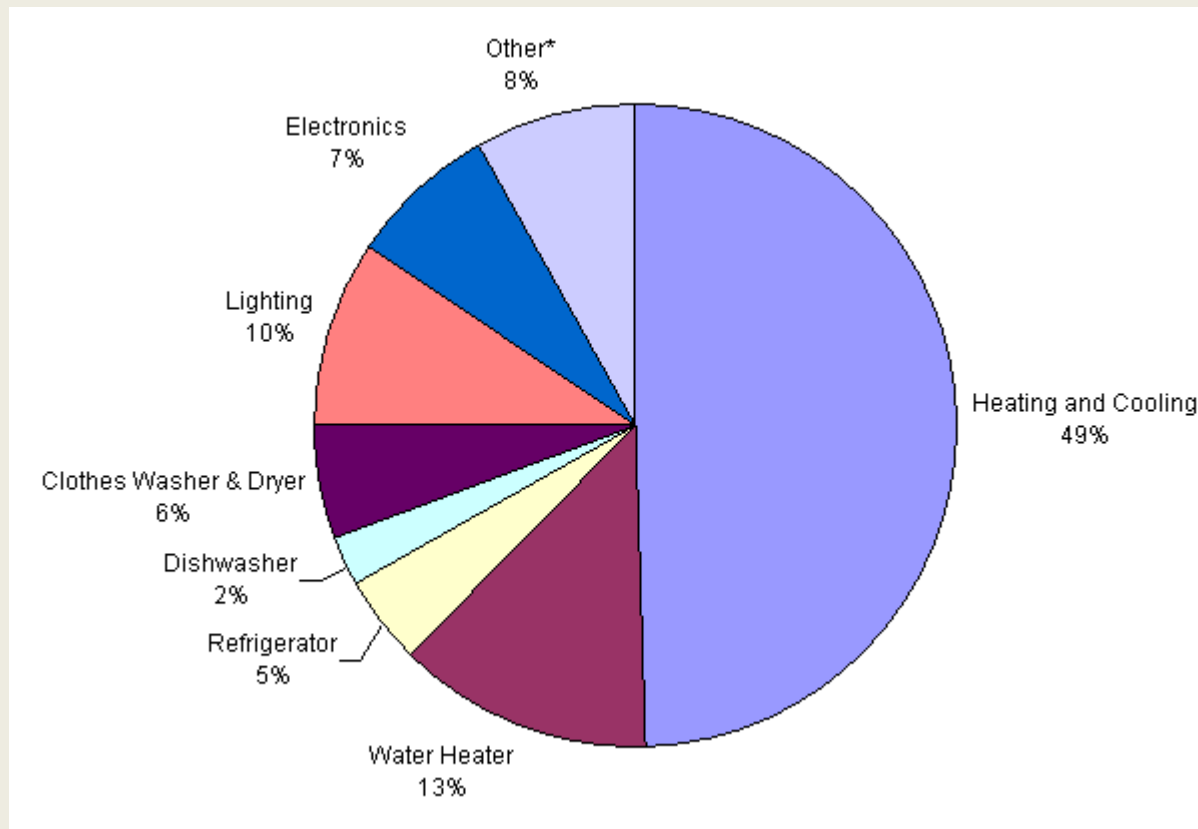
## 2. Energy efficient residential real estate credit for homebuilders

- Contractors who construct residential homes are allowed to claim a federal tax credit of \$2,000 per home, if the home is completed after August 8, 2005 and before January 1, 2010, and is certified to be at least 50% more energy efficient than comparable homes (the baseline is the 2004 supplement to the 2003 International Energy Conservation Code); the building envelope must provide heating and cooling that is 10% below that of a comparable dwelling. A reduced credit is available if a 30% efficiency level is reached, but not 50% efficiency. The intent is to encourage builders to invest a little more in the cost of these efficiencies by offsetting some or all of the cost through the available credit. And, 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 professional engineer or a contractor licensed in the jurisdiction where the home is built. Many homebuilders who build in accordance with LEED standards will qualify for this credit, and others who might not qualify could do so with relatively minor construction changes. Since the credit is *per qualifying home*, this can add up to a sizeable tax benefit. The certification must come from an unrelated individual certified by RESNET (or an equivalent rating network) to conduct these studies, using software approved by 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 if IRS were to conduct an inquiry or examination.
- These provisions are outlined in Internal Revenue Code Section 45L and further guidance is provided by IRS Notice 2006-27. The credit coordinates with the investment tax credits under Code Section 38, and does reduce the taxpayer's basis in the building. Unused current year credits may be carried back one year or forward up to twenty years.

# 3. Residential home improvement tax credit for consumers

- 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 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, and these improvements only qualify if made to existing homes. The improvements must meet certain efficiency guidelines published by IRS, and the vendor will typically be able to determine if an item qualifies or not. These rules are codified in Code Section 25C.

# Where does the money go?



## 4. Residential tax credit for purchase of certain energy efficient items

- For existing homes *and new construction* through 2016, a 30% tax credit is available for geothermal heat pumps, solar panels, solar water heaters, small wind energy systems and fuel cells. 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 residence, these credits are 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 these credits.

# 5. Accelerated depreciation for SmartMeters and Smart Grid Systems

- The Emergency Economic Stabilization Act of 2008 amended Internal Revenue Code Section 168 to shorten the recovery period of this property from twenty years to ten years. The property must be used in a trade or business and placed in service after October 3, 2008.

# Kentucky incentives

- Like many states, Kentucky has enacted numerous provisions to encourage energy efficiency for real estate located in the state. These incentives are typically smaller than the Federal incentives, but still can add up to significant savings and are often overlooked.
- Individual taxpayers who install certain energy efficiency measures during the period 2009 through 2015 qualify for a 30% state income tax credit on the cost of the improvement. These measures include:
  - For most of the same properties outlined in 3. above, subject to limits per item ranging from \$100 to \$250, with a \$500 total. Applies to personal residences and rental properties.
  - Solar, wind and geothermal installations with limits ranging from \$250 to \$500. Applies, to personal residences, rental properties, and commercial properties.
  - Photovoltaic (PV) System installations qualify for a credit of \$3 per watt rated capacity, up to \$500.
  - \$800 credit for building a new Energy Star home (credit is reduced by above credits claimed).
- All Kentucky taxpayers qualify for a 30% credit on the cost energy efficient HVAC systems (\$500 maximum) and interior lighting systems (\$500 maximum).
- Business taxpayers are eligible for a variety of income tax and sales tax benefits if they invest in certain carbon-capture ready alternative energy or renewable energy facilities. These recoveries can total as much as 50% of the cost of the construction, but must be certified in advance by the Kentucky Economic Development Finance Authority. Also, sales tax refunds are available for manufacturing facilities which purchase machinery or equipment that reduces energy consumption by at least 15%.

# Highlights of 2008 Kentucky Legislative Session

## State Tax Credits On Energy Efficiency and Renewable Energy Highlights from the Kentucky 2008 Legislative Session

This document is a summary of the tax credit provision of House Bill 2 from the 2008 Legislative Session. The full bill may be viewed at <http://www.lrc.ky.gov/record/08RS/HB2/SCS1.doc>. These credits are only available for taxable years beginning after Dec. 31, 2008 and beginning before Jan. 1, 2016, and apply only to properties located within the Commonwealth of Kentucky. Anyone wishing to take advantage of these tax credits is advised to save copies of invoices, purchase receipts, installation contracts, proof of solar installer's NABCEP certification, and any other information that may help to verify credits being taken. For specific questions on these state tax credits contact Regina Ritchey of the Kentucky Division of Corporation Tax at 502-564-7256 or [regina.ritchey@ky.gov](mailto:regina.ritchey@ky.gov).

Product Category	Product Type	Tax Credit Specifications	Tax Credit	Notes
<b>Residential energy efficiency</b> (Total tax credits for this subsection may not exceed \$500 per taxpayer) (Sec. 12)	Upgraded insulation	- Attic: at least R-38 - Exterior walls, crawl space, and basement exterior wall: at least R-13 - Floor: at least R-19	30% of installed cost, not to exceed \$100	- Must be existing principal residence or a residential rental unit owned by taxpayer. - Eligible for tax year installed.
	Energy-efficiency windows and doors	ENERGY STAR labeled and NFRC certified for North-Central Climate Zone	30% of installed cost, not to exceed \$250	- Must be existing principal residence or a residential rental unit owned by taxpayer. - Eligible for tax year installed.
	Qualified heat pumps, water heaters, geothermal heat pumps, central AC, or furnaces	As eligible for federal tax credits under 26 USC Sec. 25C*	30% of installed cost, not to exceed \$250	- Must be existing principal residence or a residential rental unit owned by taxpayer. - Eligible for tax year installed.
<b>Solar and wind</b> (Total tax credits for this subsection may not exceed \$500 per dwelling; nor \$1000 per commercial or multi-family property) (Sec. 12)	Solar space or water heating, wind turbine or machine	- As defined in HB2 of 08 Regular Session, Section 11** - Installed by NABCEP installer	30% of installed cost, not to exceed \$500 per eligible system if a dwelling unit, nor \$1000 per commercial property	- Must be existing principal residence, or a residential rental unit, or commercial property owned by taxpayer. - Eligible for tax year installed.
	Solar photovoltaic system	- As defined in HB2 of 08 Regular Session, Section 11** - Installed by NABCEP installer	\$3 per watt direct current of rated capacity	- Must be existing principal residence, or a residential rental unit, or commercial property owned by taxpayer. - Eligible for tax year installed.
<b>Commercial energy efficiency</b> (Total tax credits for this subsection may not exceed \$1000) (Sec. 12)	Energy efficient interior lighting system or HVAC or hot water system	As eligible for federal tax credits under 26 USC Sec. 179D+	30% of installed costs, not to exceed \$500 per eligible system.	- Must be commercial. - Eligible for tax year installed.
<b>New homes</b> (Sec. 13)	New ENERGY STAR single-family, site-built or manufactured home	As defined by ENERGY STAR program administered by EPA++	\$800 for site-built home; \$400 for manufactured home	Credit goes to builder of new home for year completed or seller of manufactured home for year of sale, used as principal residence.

\* For more information on qualified energy property specifications see <http://www.gpoaccess.gov/uscode/index.html>, then search on "26USC25C".

\*\* For more information on solar and wind property specifications see <http://www.lrc.ky.gov/record/08RS/HB2/SCS1.doc> to view House Bill 2, 2008 Regular Session.

+ For more information on commercial energy efficiency property specifications see <http://www.gpoaccess.gov/uscode/index.html> then search on "26USC179D".

++ For more information on ENERGY STAR new home specifications see [http://www.energystar.gov/index.cfm?c=bldrs\\_lenders\\_raters\\_homes\\_guidelns](http://www.energystar.gov/index.cfm?c=bldrs_lenders_raters_homes_guidelns), to view

"Technical Resources: Guidelines for ENERGY STAR Qualified Homes."

Disclaimer: This document is for informational purposes and should not be used for tax preparation. See appropriate regulations or statutes, or consult with a qualified tax advisor or the Department of Revenue for actual tax benefits available.

# Summary

- These rules are rapidly developing and somewhat disorganized. Taxpayers who are contemplating construction or improvement to real estate would be well advised to review in depth all of the provisions at the federal, state and local level in their jurisdiction. Often, the local or state finance office will be very helpful for gaining a full understanding of all of these tax incentives, in addition to providing information regarding any loan or grant incentives that might be available. With the recent flurry of federal stimulus that is intended to generate much construction around the country, it is likely that many more changes are to come.

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