# Guest Commentary

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## Tax-Smart Construction: Newest Building Block of Success

**The difference between the nail and the screw may be worth millions to contractors who learn how to apply tax procedures to materials and systems**

As ever-changing laws beget new risks to contractors, fresh opportunities emerge for industry leaders who desire to build a competitive edge. A contractor who is up to date with new legal requirements and best practices that can mitigate risk and increase profits for owners of buildings will be strongly sought after as a leader in the field. Owners and owner representatives such as architects, brokers, engineers and certain construction managers select contractors or builders who help enhance their competitive advantage and stature in the industry while simultaneously building client loyalty and industry leadership.

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### Financial Benefits

Optimal best practices include the use or disclosure of green-build options and tax (investment) credits, environmental-management techniques and now, tax-smart construction techniques. Tax-smart construction encompasses the practice of using design, materials, systems and methods of installation that offer substantial tax and financial benefits to the project or owner. This includes tax deductions and credits and the new tax-compliant "cost segregation" opportunities.

### Benefits of TSC

Internal Revenue Code Section 179 D allows an owner to deduct all or a portion of the costs of select energy-efficient commercial building property in service before Jan. 1, 2009, limited as follows:

Deductions cannot exceed the aggregate lifetime per building cap. Tax basis is reduced by the 179 D deductions.

IRC Section 48 provides a 30% income tax credit of any energy property placed in service before Jan. 1, 2009, such as depreciable solar energy equipment used for generating electricity, heating or cooling, delivering hot water, solar heat or illuminating interiors with sunlight or fiber optics.

Cost-segregation depreciation reveals that the design and installation choices between the nail and the screw may be worth millions to owners. Contractors may have a duty to disclose such options to owners. The IRS recently affirmed the use of the cost-segregation depreciation method in Rev. Proc. 2004-11.

In a nutshell, it is the reclassification of existing or new real property structural components (IRC 1250) as personal property (IRC 1245). It means that an owner or leaseholder can depreciate assets faster and reduce income taxes, insurance premiums and real estate property taxes, as well as increase cash flow, return on investment and property valuation.

Tax-smart construction may apply to existing commercial real property, tenant improvements (old or new), construction, build-outs, renovation, remodeling, restoration, fit-outs and demolition.

Step one is to obtain a cost-segregation study. For existing buildings, this entails an onsite review to reclassify building components. For buildings in the design stage, this would entail proactive steps to include tax-smart architectural design with respect to materials, systems and methods of installation.

Benefits to the owner generally reclassify 10% to 40% of the depreciation base of a building. For example, an office warehouse complex with a cost basis of $5.1 million could segregate approximately 23% into five-, seven- and 15-year lives producing additional depreciation of $750,000 and deferring taxes of approximately $315,000. Larger projects add more zeros.

HVAC units, plumbing and electrical systems, wall coverings, lighting or removable partitions could save the owner substantial money in taxes and expenses, and concomitantly increase profitability, return on investment and property valuation.

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The criteria to determine reclassification of building components as determined by the Internal Revenue Service include, “1. whether the asset is movable or removable; 2. how the asset is attached to real property; 3. the design of the asset; and 4. whether the asset bears a load” (Revenue Ruling 75-178, 1975-1 C.B. 9).

The United States Tax Court, in deciding the now-landmark Whiteco case, held that the “inherent permanency test” and the “Whiteco factors” include six questions designed to ascertain whether a particular asset qualifies as tangible personal property. These questions, referred to as the “Whiteco factors,” are:

- Can the property be moved and has it been moved?
- Is the property designed or constructed to remain permanently in place?
- Are there circumstances that show that the property may or will have to be moved?
- Is the property readily movable?
- How much damage will the property sustain when it is removed?
- How is the property affixed to land?

It should also be noted, however, that movability is not the only determinative factor in measuring inherent permanency (In L.L. Bean, Inc. v. Comm., T.C. Memo. 1997-175, aff'd, 145 F.3d 53 (1st Cir. 1998)). Many other factors are considered, including, but not limited to, “intentions regarding the removal” and the “manner in which an item is attached to a building or to the land,” among others.

| Threshold Test | Deductions/Limitations |
|---|---|
| Exceeding 50% threshold | Full Cost of EECBP up to $1.80 per sq ft |
| Exceeding 16⅔% but less than 50% | $0.60 per sq ft |

In a nutshell, if an item is installed with a removable fastener, with the intent to make it removable without creating major damage, then that item may qualify for faster depreciation. That could then trigger increased deductions, cash flow, return on investment and property valuation.

### Optimal Best Practices

There are four types of specialty services that provide savvy contractors with ways to move their businesses to new levels of efficiency and profitability:

- Tax-smart construction, which offers substantial tax and financial benefits to the project or owner;
- Green-build options, which offer substantial environmental efficiencies to society while offering financial benefits to the project or owner;
- Integrated risk/competitive edge policies, which acknowledge risk circumstances and apply not the cheapest, but

the optimal alternative solution, and turn it into a competitive advantage;

- Environmental-management systems, which identify what a company or other organization is going to try to do to protect the environment, improve its performance and then follow through. (www.ndems.cas.unc.edu)

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