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CONSTRUCTION

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TAX-ADVANTAGED CONSTRUCTION - TAX BENEFITS FOR NEW CONSTRUCTION PROJECTS

For new construction projects, the project owner must manage several tasks throughout the project life cycle. In addition to managing teams for design, risk management, project management, etc., it is important for owners to understand the regulations for federal asset depreciation and filing property taxes. Knowing the different asset classifications and proper filing requirements can result in a significant increase in cash flow.

Employing a reputable team of industry tax specialists that combines knowledge and experience in the regulations of federal asset depreciation and property taxation can maximize the tax benefits of a new construction project. These benefits include maximizing cash flow through the proper classification of assets for federal depreciation reporting and minimizing the property tax assessment through the proper reporting of construction costs to the local assessing authority. In addition, this article will explain how to coordinate additional benefits relating to IRS Section 179D energy-efficient commercial building deduction.

In many instances, an owner will not consider the tax consequences for a new construction project until it is too late, which can have a detrimental impact on the bottom line. As a result, the owner can incur tens of thousands of dollars in higher property tax assessments, depending on how the construction budget is declared to local authorities, and miss valuable federal tax depreciation deductions.

IRS REGULATIONS PERMIT COST SEGREGATION

The IRS regulations generally indicate that assets that are not building components can be classified as Site Improvements (15-year life), Office Furniture (seven years), Information Systems (five years), and various other classes of personal property, depending on the business activity performed at the building. The tax life of personal property ranges from three years to more than 10 years. Examples of federal tax lives (years) for personal property are shown in **Figure 1** on the following page.

Figure 1. Federal Tax Lives (Years) for Personal Property

ASSET DESCRIPTION	SERVICE CO.	MANUFACTURER
Parking lot, fencing and landscaping	15	15
Specialized air-conditioning systems	5	5
Dedicated electrical to personal property	5	5, 7 or 10
Plumbing piping to personal property	5	5, 7 or 10
Moveable partitions	5	7
Decorative features	5	7 or 10

Beginning with the Investment Tax Credit in the 1960s, taxpayers were able to componentize new construction into assets for federal tax depreciation. In 1986, the IRS changed the regulations to replace componentization with the accelerated cost recovery system and the modified accelerated cost recovery system. The life of a buildings was lengthened from 19 years to 31.5 years and a methodology was introduced that outlined how lives were assigned to short-lived assets. In 1993, the IRS increased the life of a building to 39 years.

In 1999, the IRS lost a milestone case in *Hospital Corporation of America [HCA] v. Commissioner*, 109 TC 21 (1997), which affirmed the taxpayer's ability to continue to segregate certain short-lived assets. Critical to the Tax Court's analysis was that by formulating accelerated depreciation methods, Congress intended to distinguish between components that constitute IRC Section 1250 class property (real property) and property items that constitute Section 1245 class property (tangible personal property). However, an IRS chief counsel advisory warned taxpayers that an "accurate cost segregation study may not be based on noncontemporaneous records, reconstructed data or taxpayers' estimates or assumptions that have no supporting records" (CCA 199921045).

NEW ASSET CAPITALIZATION REGULATIONS

In late 2013, the IRS issued new final regulations relating to the capitalization of tangible property. Under the new rules, the business must carefully review how it capitalizes new costs, such as a new building or improvements to an existing building, which requires the identification of the primary components of the building and the specifically enumerated building systems.

Primary Components of a Building:

- Structure
- Floors
- Walls
- Windows
- Doors
- Interior partitions
- Ceilings
- Permanent coverings (paneling or tiling)

Specifically Enumerated Building Systems:

- Heating, ventilation, and air-conditioning systems
- Plumbing systems
- Fire protection and alarm systems
- Gas distribution systems
- Electrical systems
- Security systems
- Escalators
- Elevators

TAX-ADVANTAGED CONSTRUCTION

Tax-advantaged construction (TAC) is a unique proactive approach that identifies short-lived assets that are buried within the construction costs and identifies additional assets that are not attainable through a traditional cost-segregation study. TAC focuses on three key elements: design review, discovery, and documentation.

- **Design Review**

  Early involvement with the entire project team enables a review of the design development drawings and an interview with the design team to understand the intended design and functional requirements of both the building and the business process that will be operating in the new building. By understanding the unique design specifications, the TAC process will be able to identify new assets that can qualify for shorter recovery and bonus allowance, if extended by Congress for 2013 and future years. TAC focusses particular attention on the electrical and lighting circuiting, heating and air-conditioning, plumbing systems, decorative elements, special construction features, and interior finishes.

- **Discovery**

  The goal of TAC is to discover and develop supporting documentation of the building components, building services, and process requirements. This approach identifies the elements eligible for shorter recovery periods, which are additive to traditional cost-segregation analyses, through a series of meetings with the design professionals and owner. Through this collaborative process, TAC can help the owner and design team uncover additional benefit opportunities that exist within the design and provide updated benefit estimates based on the acceptance of the recommendations.

- **Enhanced Documentation**

  A critical objective of the TAC methodology is to provide thorough contemporaneous documentation of the construction project, from design to capitalization, including detailed documentation to meet the enhanced IRS reporting standards. Each report:

  - Establishes the design requirements of the business processes and the building function
  - Documents the supporting materials from the design and construction professionals
  - Prepares construction drawings identifying the short-lived assets, collects images of the assets;
  - Develops an index of justifications for the report that provides the relevant tax authority from U.S. Tax Court rulings, IRS Revenue Procedures, and regulations to support the identified short-lived assets

As a result of various Tax Court cases and changes to the regulations pertaining to the segregation of construction costs, the IRS requires contemporaneous documentation of the construction project and the componentization of assets. Depending upon the nature of the project, anywhere from 20 percent to 60 percent of a project can be classified in a shorter tax life class and the cost can be recovered much faster than the current 39-year life for a building. The faster recovery increases depreciation expense and lowers taxable income, resulting in significant present value cash savings in the early ownership of the project, which is then available to the business for alternative investment.

FEDERAL TAX CASH FLOW BENEFITS

The benefit of a TAC study is normally quantified as the net present value difference between the accelerated depreciation deductions resulting from the study and the straight line recovery of real property over 27.5 or 39 years. The net present value benefit can range from 4 percent –8 percent of the analyzed project cost (exclusive of land and the owner's equipment). Compared to a traditional cost segregation study, a TAC study may find up to an additional 20 percent of project cost eligible for shorter recovery. On a $10 million owner-occupied construction project, the potential net present value benefit can range from $0.5 to $0.7 million.

TAX DEDUCTIONS FOR ENERGY EFFICIENCY

The Energy Policy Act of 2005 was enacted to incentivize higher-efficiency features incorporated into new building construction and renovation. Projects that seek Leadership in Energy and Environment Design certifications may also qualify for the IRS Section 179D energy tax deduction. The IRS requires a qualified engineering analysis that uses software approved by the Department of Energy to compare the design to benchmark standards for HVAC efficiency, lighting efficiency, and exterior envelop efficiency. The owner or designer benefits from a one-time deduction of up to $1.80 per square foot in the year the building cost is capitalized, resulting in immediate tax savings. While Section 179D expired in December 2013, the House Ways and Means Committee is currently deliberating the renewal of this tax benefit. Owners should monitor this situation and incorporate a 179D study into their tax planning once it is approved.

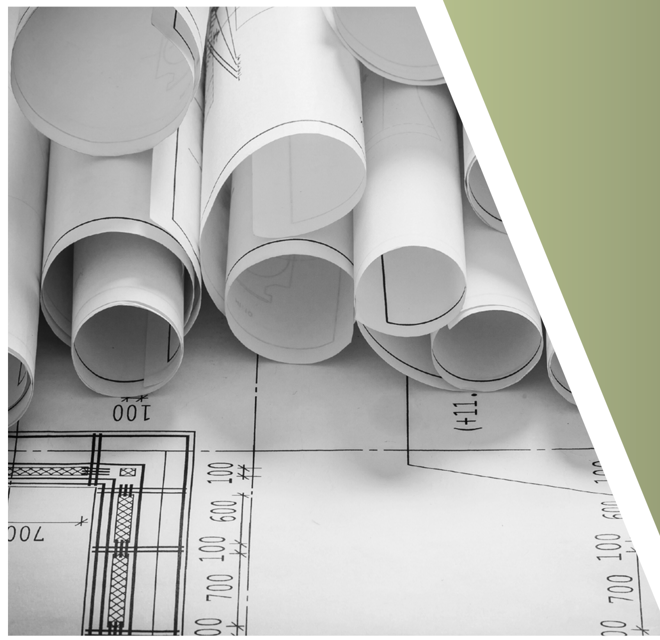
PROPERTY TAX BENEFITS

Timing is critical to minimizing a property tax assessment. An owner seeking incentives and a property tax abatement for a new construction project will typically disclose the maximum cost of their new project in order to maximize those incentives. However, the local jurisdiction may rely on the published project costs for developing its property tax assessment for the new building. Before declaring the cost of a new project for zoning and permitting purposes, consideration must be given to:

- Reviewing the nature and scope of the project and business activities
- Determining whether obsolescence is a factor;
- Identifying costs associated with expediting the project or changes in design
- Property reporting the costs that pertain to the local tax authority jurisdiction

Involving a property tax expert at the outset helps to ensure that the proper cost of a new project is reflected in local jurisdiction permitting processes, ultimately reducing the property tax assessment.

CONCLUSION



Performing a tax-advantaged construction analysis and property tax analysis from the outset of the project maximized the tax-related benefits of the project through a process of design review, discovery, and developing the best supporting documentation. This approach saves the owner time, expense, and reduces frustration from attempting to maximize these benefits after the project is complete and in service. Potential cash flow benefits of a new construction project include minimizing taxable income for federal reporting purposes and permanently minimizing the property tax assessment.

ABOUT THE AUTHORS

Joseph J. Calvanico is a director of the Valuation and Financial Risk Management practice at Navigant. He has more than 30 years of experience in the valuation of real estate and machinery/equipment for a variety of industries and a variety of purposes. Purposes include property tax, bankruptcy, financing, purchase price allocation, and many more.

Andrew P. Campbell is an associate director with Navigant Capital Advisors, the dedicated corporate finance business unit of Navigant. He has been actively involved in providing fixed-asset valuation and consulting services for more than 25 years, and specializes in the valuation of personal property, cost segregation studies and federal tax depreciation reviews, and performing building cost componentization studies for higher education and research facilities for GASB reporting requirements.