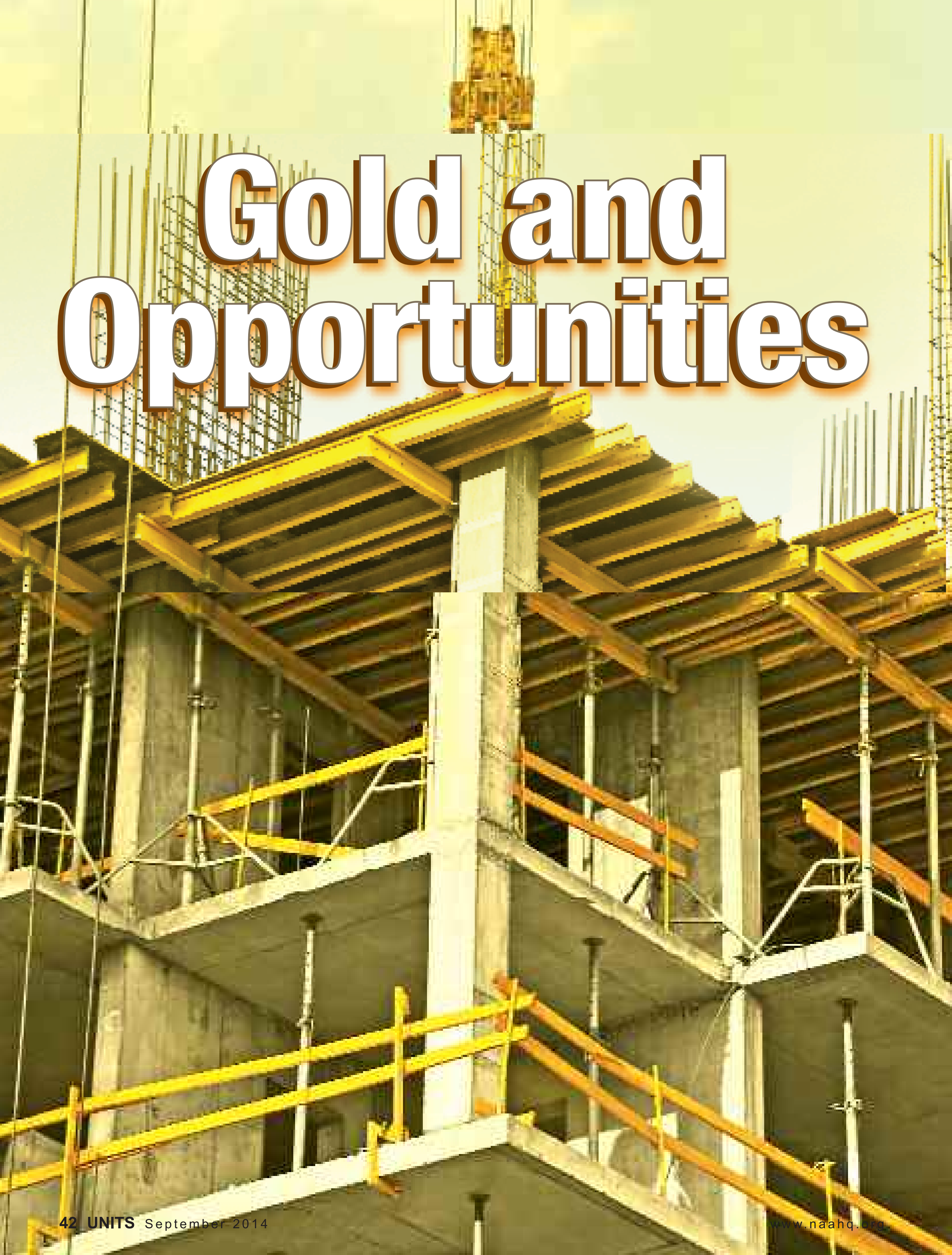
Gold and Opportunities



New cost segregation-related regulations and energy-efficiency tax incentives provide excellent options for owners of rental housing.

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The United States is increasingly becoming urbanized, and with constantly expanding city populations, a greater number of apartments will need to be built to accommodate the growth. The new regulations available for building owners allow great opportunities for reducing the costs of new apartment construction and renovations because of cost segregation and incentives for energy-efficient equipment.

By combining a cost segregation study at the time of purchase or new construction with a plan for taking advantage of future repairs, apartment owners can significantly reduce the costs of their initial purchase, as well as any repairs that need to be addressed during the building's lifetime.

Increasing U.S. Urbanization

Currently, there are approximately 255 million people living in U.S. cities. It is estimated that by 2020, 85 percent of the U.S. population will be living in cities, meaning an additional 40 million people will be living in urban areas within the next six years. According to predictions from Unicef, by 2050, 90 percent of the population, or an additional 100 million people, will be living in cities. This massive influx of people will need spaces to live.

Projections reveal an expected 700,000 new apartments to be built by 2018. Across the country, in what is called the "Manhattanization" of the U.S., many new high-rise apartment communities of 15 stories or above are being built. In 2014, 74 communities taller than 15-stories are expected to be built and, in 2015, 81 more are projected.

According to Mark Hogan's article, "The Real Costs of Building Housing," from the February 2014 edition of The Urbanist, on average, a 100-unit apartment building consisting of 800-square-foot apartments costs about $10 million to $50 million, depending on the area of the country. Cost segregation and

Table 1

Cost Segregation and Energy Efficiency Incentive Categories' Depreciation Methods

Category	*Depreciation Method*	*Items Included*
Building	27.5 Year	Walls, roof, foundation, building lighting, doors, beams, windows, fire protection, etc.
Land Improvements	15 Year	Parking lot, site sewer, paving, curbing, fences, landscaping, non-building related excavation, Dumpster pad, exterior light posts, parks, tennis courts, dog parks, gardens
Personal Property	5 Year	Carpet, blinds, shelving, appliances, wiring and plumbing connected to appliances, mirrors, etc.
Soft Costs	Distributed across all categories	Testing, insurance, permits, blueprints, fees, architectural/engineering, construction labor, general conditions, job site security, etc.
Alternative Energy Projects	Typically 5 year	Geothermal, combined heat and power (CHP), wind, solar P.V., etc.
EPAct/Section 179D	Up to $1.80/sq.ft. first year accelerated depreciation	Interior lighting, HVAC, building envelope (walls, windows, roof, doors)

other incentives for energy efficiency can significantly help alleviate these building costs.

Cost Segregation

Cost segregation (CS) is a method of allocating a building's assets to take advantage of the time-value of money. Established in 1997, CS leverages years of case law and the Modified Accelerated Cost Recovery System (MACRS), issued by the IRS in 1993. As opposed to normally depreciating all of an apartment building's assets over 27.5 years, these assets are able to be broken up into different "buckets" and depreciated over quicker schedules depending on their function. In most cases, for a building, the ability to depreciate some assets over a quicker schedule can return an average of 5 percent to 10 percent of the project cost based on the added Net Present Value (NPV) generated. In other words, it is like a 5 percent to 10 percent coupon on the project.

The buckets and depreciation schedules that categorize cost segregation are illustrated in Table 1.

Understanding Depreciation Methods

In an apartment community ("building" in the chart), the components that make up the physical building are treated as 27.5-year property. This includes the walls, roof, foundations, building lighting, doors, beams, windows, fire protection, etc.

Any item or improvement defined as "Land Improvements" is categorized as 15-year depreciable equipment. These include the excavation of the site, paving, curbing fencing and exterior light posts, but can also include outdoor entertainment areas such as parks and tennis courts.

Many high-end apartments have focused more on developing the exterior areas to attract residents. Sustainable initiatives have placed further interest in improving the outdoor areas such as parks, dog walks and car-charging stations. All of these would be considered 15-year property, and a cost segregation study can assist in reducing the overall costs of these installations.

Items that are permanent but not integral to the building's operation ("Personal Property") are categorized as 5-year property. In an apartment, this would include carpeting, tile, shelving, furniture, décor, permanent appliances such as an oven, dishwasher or washer and dryer, as well as all electricity and piping connected to the equipment.

Many luxury apartments come pre-furnished with high-end appliances such as wine chillers, coffee makers, and multiple ovens and stovetops. These, along with their respective electrical and plumbing connections, likely would be considered as 5-year property. Even communities with a non-luxury focus are including features traditionally found only in higher-end properties, such as stainless steel appliances and upgraded floor materials. With more and more apartments placing a greater emphasis on more expensive furnishings and appliances, performing a cost segregation study to categorize these items as 5-year property can recover much of the costs.

Costs associated with the construction and planning of the building (“Soft Costs”) are distributed proportionally across all class life categories. This includes the construction labor, architectural and engineering costs, blueprints, testing, job site security, insurance, permits and other fees. When planning whether to perform a cost segregation study, the impact of depreciating soft costs must not be overlooked. With increasing urbanization, costs for permits and associated fees are rising. A cost segregation study can help reduce the strain of these increasing construction-related fees.

New Repair Regulations

In October 2013, the IRS issued new permanent regulations (TD 9636) for the treatment of Capital and Repair related purchases. When performing a cost segregation study, the properties allocated into depreciation buckets can be further segregated into Building Systems, describing the role they serve in the building. These categories are as follows:

- HVAC
- Electrical
- Elevators
- Security Systems
- All Other
- Plumbing
- Escalators
- Fire Protection & Alarms
- Gas Distribution

When faced with a future one-for-one replacement of Building System equipment, buildings that have conducted a Cost Segregation down to the Building System level may be able to expense the basis of the new equipment. The replacement must not be a betterment and must replace less than 50 percent of that type of similar functioning Building System equipment. For example, a facility conditioned with 10 package HVAC units can replace up to four with similar equipment and expense the cost of the replacement, thereby reducing the after-tax cost of the replacement.

In the scenario where the new equipment must be capitalized, the taxpayer may be able to write off the remaining cost basis of the old assets, so long as they have identified the single cost of these assets.

Amerisouth Case

In 2012, the IRS issued Amerisouth XXXII., Tax Court Memo 2012-67, an unfavorable ruling on the cost segregation claim by apartment owner Amerisouth XXXII, Ltd. In 2003, Amerisouth acquired an apartment community, which upon purchase began a $2 million renovation. During their cost segregation study, roughly 33 percent of the property was classified into 5- or 15-year buckets. The IRS took the study to tax court, but by the time the case was tried Amerisouth had sold the property and stopped all communication with the court and its own lawyers, who then withdrew from the case.

Had Amerisouth filed a post-trial brief, the case would have been dismissed. However, since it was not filed, the court interpreted this as conceding all uncontested matters.

The court reviewed each of the categories Amerisouth had identified for faster depreciation:

- special plumbing
- special HVAC
- finish carpentry
- interior windows and mirrors
- site preparation
- sanitary sewer systems
- special electric
- site electric
- millwork
- special painting
- water distribution systems
- gas lines

The only components ruled in Amerisouth’s favor were:

- refrigerators
- washer and dryer outlets
- dryer vents
- ground watering timers and outlets
- stoves
- cable, telephone and Internet outlets
- gate components
- surveillance cameras and TVs

It is overwhelmingly likely that had Amerisouth presented a defense, the ruling would have turned out differently. The ruling reinforces the fact that if conducting a cost segregation study, it is recommended to use professionals who have experience dealing with the IRS.

EPAct Tax Credit

Assuming Congress extends another depreciation benefit comes in the form of the EPAct Section 179D tax deduction for energy efficiency. Pursuant to Section 179D of the Energy Policy Act (EPAct) and its underlying ASHRAE (American Society of Heating Refrigeration and Air Conditioning) building energy code, commercial apartment buildings four stories and above are eligible for energy efficiency tax deductions of up to $1.80 per square foot. If a building’s energy reducing investment doesn’t qualify for the full $1.80 per square foot deduction, deductions are available for any of the three major sub-systems, including:

- Lighting
- HVAC (Heating, Ventilation and Air Conditioning)
- The building envelope

Each component can qualify for up to $0.60 per square foot EPAct tax deductions. The building envelope is anything on the perimeter of the building that touches the outside world including roof, walls, windows, doors, foundation and related insulation layers.

Triggering the EPAct Benefit

There are many different ways to trigger an EPAct benefit in apartment communities. Unlike utility rebates and other financial incentives for energy efficiency, EPAct is not technology-specific. As long as a building meets the overall energy saving requirements, it will be eligible for up to the $1.80-per-square-foot tax deduction. Building owners have found success using the benefit to pay for high-end energy efficient technologies such as LED lighting and Variable Refrigerant Flow/ Variable Refrigerant Volume units (VRF/VRV), although centralized chillers and fluorescent lighting often trigger a benefit as well.

For apartment communities, HVAC is the largest energy-related cost. VRF/VRV is a highly efficient air conditioning system, ideal for commercial buildings because of the ability to individualize control for different zones/rooms. The system is incredibly beneficial for buildings with varying cooling needs, such as apartments, since individuals want to be able to control the temperature in their area. Individual control in VRF/VRV systems creates energy efficiency and allows for flexibility in building design. On average, VRF/VRVs will annually reduce total energy costs by at least 20 percent.

In addition, many apartment buildings are currently installing LED lighting. During the past few years, LED lighting has dropped dramatically in price while offering immense energy savings and bulb life.

As costs drop, so too does the payback period. Certain LED lighting projects have a payback period of only two years. The total energy cost savings from combining both LEDs and VRF/VRVs can often exceed 50 percent, and trigger a $1.80-per-square-foot EPAct tax deduction.

Many apartment buildings also have on-site parking garages. In parking garages, the largest energy user is lighting, which is normally on 24/7. By retrofitting parking garages with new LED technologies or other energy-efficient lighting, apartment building owners can reduce energy costs while capturing large EPAct tax incentives of up to $.60 per square-foot.

By conducting a cost segregation study, the energy efficiency tax deduction and alternative energy credits can be realized. By combining all three, a significant portion of the depreciable basis can be eliminated.

Now Is The Time To Act

With the increasing urban push and the demand for more apartment communities, now more than ever is the time for apartment building owners to take advantage of the new cost segregation and energy efficiency opportunities. Conducting these studies with experienced professionals and integrating them into the design process is the most secure way to guarantee maximized current and long-term incentives.

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