The Energy Tax Aspects of Drug Stores

By Charles Goulding, Jacob Goldman and Joseph Most

Charles Goulding, Jacob Goldman and Joseph Most discuss how the EPAct can be used to save tax and energy costs for the three major drug store chains as the market continues to grow.

The drug store sector has grown tremendously in recent years and has seen the emergence of national sector-wide domination by three companies: Walgreens, CVS and Rite Aid. As the industry has evolved to three leading companies, it has increasingly focused on energy management. Considerable tax incentives are available to complement these companies' advanced energy-efficiency initiatives.

The EPAct Tax Opportunity

Under the Energy Policy Act (EPAct)[1] and Code Sec. 179D, drug store owners or tenants making qualifying energy-reducing investments can obtain immediate tax deductions of up to $1.80 per square foot. Alternatively, if the building project doesn't qualify for the maximum $1.80-per-square-foot immediate tax deduction, there are tax deductions of up to 60 cents per square foot available for each of the three major building subsystems: lighting, HVAC and the building envelope. The building envelope is every item on the building's exterior perimeter that touches the outside world including roof, walls, insulation, doors, windows and foundation.

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Chart 1 illustrates the potential total EPAct tax deduction for the major drug store chains.

Drug Store Tax Planning

Lighting

Building lighting comprises a large portion of drug store energy use. It is important to realize that, effective January 1, 2009, most probe-start metal halide lighting may no longer be manufactured or imported into the United States. Effective July 1, 2010, most T-12 lighting may no longer be manufactured or imported into the United States. Fortunately, the leading three drug store companies are all ahead of the pack in this regard, as they have recently upgraded to at least T-8 lighting.[2] A lighting retrofit, similar to what these companies have done, can easily reduce lighting electricity costs by 40 to 60 percent. Chart 2 shows when EPAct lighting tax savings are applicable for typical drug store spaces.

LED Lighting Conversion

Previously, most lighting upgrades were to T-5 or T-8 fluorescent bulbs. However, the recent trend has been to upgrade to the new technology, LED lighting.[3] The leading three drug stores have started to phase in LED lighting. We anticipate that in the near future they will fully convert to LEDs. For example, CVS has started to replace all of their lighting in noncritical store areas with LEDs.[4] Walgreens' newest stores use LED lighting for coolers, freezers and exterior signage.[5] We believe the next step will be upgrading to LEDs

Chart 1

Major Drug Stores Potential Energy Efficiency EPAct Tax Deductions							
			Lighting				
Chain	Stores	Gross Square Footage	Minimum Deduction	Maximum Deduction	HVAC Maximum Deduction	Building Envelope Maximum Deduction	Total
Walgreens/Duane Reade[2]	7,753	80,824,700	$ 24,247,410	$ 48,494,820	$ 48,494,820	$ 48,494,820	$ 145,484,460
Walgreens	7,496	79,000,000	$ 23,700,000	$ 47,400,000	$ 47,400,000	$ 47,400,000	$ 142,200,000
CVS	7,025	67,800,000	$ 20,340,000	$ 40,680,000	$ 40,680,000	$ 40,680,000	$ 122,040,000
Rite Aid[3]	4,780	59,750,000	$ 17,925,000	$ 35,850,000	$ 35,850,000	$ 35,850,000	$ 107,550,000

Notes:
1. Walgreens recently purchased Duane Reade, a regional chain with a major market share in New York City.
2. Duane Reade Square footage based on 7,100 square foot store size average from 2003.
3. Based on 12,500 square foot average store size from 10-K.

Chart 2

Drug Store Space	25% Improvement as compared to 2001 Standard $0.30/sq.ft. Deduction Watts/sq.ft.	40% Improvement as compared to 2001 Standard $0.60/sq.ft. Deduction Watts/sq.ft.
Sales Area	1.575	1.26
Corridors	0.525	0.42
Restrooms	0.750	0.60
Enclosed Office	1.125	0.90
Electrical/Mechanical	0.975	0.78
Storage	0.825	0.66
Stairways	0.675	0.54

Chart 3

Major Drug Store Distribution Centers Potential Energy Efficiency EPAct Tax Deductions						
		Lighting				
Chain	Gross Square Footage	Minimum Deduction	Maximum Deduction	HVAC Maximum Deduction	Building Envelope Maximum Deduction	Total
Walgreens/Duane Reade	13,671,000	$4,101,300	$8,202,600	$8,202,600	$8,202,600	$24,607,800
Walgreens	13,000,000	$3,900,000	$7,800,000	$7,800,000	$7,800,000	$23,400,000
CVS	11,300,000	$3,390,000	$6,780,000	$6,780,000	$6,780,000	$20,340,000
Rite Aid	8,140,500	$2,442,150	$4,884,300	$4,884,300	$4,884,300	$14,652,900

for all mainstream store lighting. This would enable the drug store owners to take immediate substantial EPAct tax deductions.

HVAC

In addition to upgrading lighting, drug stores should use new HVAC efficiency package units and, where feasible, chillers. Store owners should take their most efficient store, combining the LED lighting discussed above and the most efficient HVAC, and have it modeled using IRS approved software to see if it qualifies for multiple EPAct tax deductions.[6] With this approach, they could plan for $1.20 to $1.80 EPAct tax deductions for every store retrofitted to that energy efficiency level or better on or before December 31, 2013.

Building Envelope

Drug stores may also qualify for tax deductions for energy-efficient upgrades to the building envelope. Examples of energy-efficient upgrade opportunities for the building envelope include new roofs and improved insulation. For instance, Walgreen's LEED-certified store in Chicago built its roof with a white coating and plants growing on top[7] (commonly called a "green roof"). CVS constructs all of their new stores with white roofs made out of environmentally preferable materials.[8]

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of an obligation, outstanding on March 18, 2012, subject to an exception for obligations that have been materially modified after March 18, 2012. For this purpose, an obligation is defined as any "legal agreement that produces or could produce withholding payments," but does not include any instrument treated as equity under U.S. tax law or any legal agreement that lacks a definitive expiration or term.

Proposed Regulations Planned

The IRS will issue proposed regulations incorporating the guidance in the Notice and will publish a draft FFI agreement and draft information reporting and certification forms.

Endnotes

1. Hiring Incentives to Restore Employment Act (P.L. 111-147).
2. Notice 2010-60, IRB 2010-37, August 27, 2010.

Discount Retail Stores

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it qualifies for multiple EPAct tax deductions. With this approach, they could plan for $1.20- to $1.80-per-square-foot EPAct tax deductions for every store retrofitted to that energy-efficiency level or better on or before December 31, 2013. If they have any existing LEED (Leadership in Energy and Environmental Design) stores, they already have a store that has an energy-simulation model, and it could quickly be evaluated to see if multiple EPAct tax deductions are in the offing. For example, Family Dollar has a LEED-certified store in Spartanburg, South Carolina, and Aldi has one in Ann Arbor, Michigan. This gives these organizations an advantage. These companies should first determine whether existing LEED models already qualify them for tax savings.

Distribution Center Tax Savings

Discount retail chains can also obtain large immediate EPAct tax deductions by retrofitting their distribution centers and warehouses. In addition to retrofitting lighting, installing new energy-efficient Cambridge heating systems can provide energy cost savings of eight percent or more over the ASHRAE 2001 building code standards. There are multiple heater technologies suitable for the distribution center market, including direct-fired gas heaters, unit heaters and infrared (radiant) heaters. If feasible, the heater should be mounted on an exterior wall to optimize the roof top solar P.V. space. As can be seen by the Chart 3, some of the retailers mentioned have very large amounts of distribution center space that are potential candidates for EPAct deductions

Conclusion

Discount retailers have become a very important property category that has recently experienced a large increase in store units. Even though the sector has enjoyed a period of success and growth during the recent economic downturn, building managers and owners need to closely manage all costs including energy cost and maintenance costs. Energy-reduction investments are a great way to keep costs down in the long-term, while receiving immediate tax deductions in the short-term. Installing energy-efficient equipment, combined with the appropriate tax planning, will be a key for continued success in the discount retail sector.

Endnotes

1. Energy Policy Act of 2005 (P.L. 109-58).
2. The building envelope is every item on the building's exterior perimeter that touches the outside world including roof, walls, insulation, doors, windows and foundation.

Drug Stores

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Sometimes the forgotten EPAct tax deduction opportunity, improvements to the building envelope, can contribute in large ways to receiving full $1.80-per-square-foot EPAct tax deductions.

LEED Certified Stores

Any drug store chain with at least one existing LEED (Leadership in Energy and Environmental Design) store already has an energy-simulation model. Drug store owners can quickly evaluate the store to see if multiple EPAct tax deductions are in the offing. For example, Walgreen's has LEED stores in Mira Mesa, Calif. and in Chicago, and has four more LEED projects in the process.[9] CVS has a LEED store in La Quinta, Calif.[10] Rite Aid uses architecture and engineering firms with LEED accredited staff.[11] This gives these organizations an advantage. These companies should first determine whether existing LEED models can be converted to EPAct models that already qualify them for tax savings. One planning technique is to take a beta store with optimized lighting, HVAC and building envelope efficiency, and to lock it in to trigger major deductions in multiple stores.

The three main drug store companies are in continuous and growing competition with each other. It is interesting to note that the first CVS and Walgreen's LEED stores are less than 200 miles from each other. In highly populated areas, it is common to see all three major drug store companies with stores in close proximity to one another other. Once a market is this saturated, achieving top-line sales growth is challenging. Therefore, all operating cost reduction, including energy cost reduction, becomes crucial.

Distribution Center Tax Savings

Drug store chains can also obtain large immediate EPAct tax deductions by retrofitting their distribution centers and warehouses. As noted by CVS, these companies have already upgraded their distribution center lighting.[12] The next step for nonconditioned distribution centers is to upgrade to new energy-efficient heating systems, such as Cambridge systems, and trigger full EPAct deductions.[13] There are multiple heater technologies suitable for the distribution center market, including direct-fired gas heaters, unit heaters and infrared (radiant) heaters. If feasible, the heater should be mounted on an exterior wall to optimize the rooftop solar P.V. space. As can be seen in Chart 3, some of the drug store chains mentioned above have very large amounts of distribution center space that are potential candidates for EPAct deductions.

Like retail stores, distribution centers need to be modeled using IRS-approved software. CVS is currently building a distribution center in Chemung County, N.Y. that it expects to be LEED certified. This area of northern New York will require a warehouse heater, and a highly energy efficient heater should support EPAct tax deductions. The existing LEED model can be analyzed to determine the opportunity to convert to an EPAct model supporting back tax deductions.

Conclusion

The "Big 3" drug stores have become a very important property category that has recently experienced a large increase in store units. In fact, the drug store sector has become a leader in energy-efficient technology upgrades. However, in order to be more competitive, these companies need to take the further steps mentioned in this article to continue to lower costs and trigger larger EPAct tax deductions. Continued installation of energy-efficient equipment, combined with the appropriate tax planning, will be an important element for continued success in the drug store sector.

Endnotes

1 Energy Policy Act of 2005 (P.L. 109-58).

2 See CVS Corporate Responsibility, *http://info.cvscaremark.com/our-company/corporate-responsibility/environment/energy-usage*; Rite Aid Environmental Responsibility, *www.riteaid .com/company/about/sustainability.jsf*; Walgreens Social Responsibility, *www.walgreens .com/responsibility/planet/Green_Initiatives .html*.

3 *See* Charles Goulding, Jacob Goldman & Taylor Goulding, *The Economic, Business & Tax Aspects of Light Emitting Diode Interior Building Lighting*, Corp. Bus. Tax'n Monthly, Jan. 2009, at 21.

4 *See* CVS Corporate Responsibility, *supra* note 2.

5 *See* Walgreens Social Responsibility, *supra* note 2.

6 *See* Charles Goulding, Jacob Goldman & Kenneth Wood, *Tax Deductions for HVAC Efficiency*, Building Operating Mgmt., Apr. 2010, at 58.

7 *See* Walgreens Social Responsibility, *supra* note 2.

8 *See* CVS Corporate Responsibility, *supra* note 2.

9 *See* Walgreens Social Responsibility, *supra* note 2.

10 *See* CVS Corporate Responsibility, *supra* note 2.

11 *See* Rite Aid Environmental Responsibility, *supra* note 2.

12 See CVS Corporate Responsibility, *supra* note 2.

13 See Charles Goulding, Jacob Goldman and Raymond Kumar, *Large EPAct Energy Tax Deduction Opportunities for Commercial Heaters*, Corp. Bus. Tax'n Monthly, Jan. 2010, at 11.

Colorado

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Conclusion

Colorado's new notice and reporting regime targets remote retailers that have no physical presence in Colorado. Under *Quill*, Colorado is prohibited from mandating that such remote retailers collect Colorado sales and use taxes. Can Colorado do an end-run around *Quill* by not directly requiring that remote retailers collect Colorado sales tax, but instead imposing even more burdensome obligations of excessive reporting (beyond that of instate retailers) if the remote retailers don't waive their constitutional right through voluntarily collection of Colorado's sales and use taxes? Since remote retailers are, by definition, the only retailers that must comply with the notice and reporting requirements, the new rules appear to impose a discriminatory burden that should fail to pass constitutional muster.