The Energy Tax Aspects of Zombie Buildings

By Charles Goulding, Joseph Most and Spencer Marr

Charles Goulding, Joseph Most and Spencer Marr discuss "zombie buildings," largely vacant properties that have fallen into disrepair, and how energy-efficient renovations breathe new life into these properties, improve economic return and qualify for large immediate EPAct tax deductions.

In the current real estate market, numerous owners are being forced to transfer their building properties back to the bank in foreclosure. In some instances, the owner can't compete for new tenants because of inadequate cash flow to cover needed renovations and can't refinance the loan because the debt exceeds the current value of the building. Other owners may have the financial capability to make capital improvements to their property, but see foreclosure as a better way to escape declining occupancy rates and an overvalued mortgage. In the interim, in both of these scenarios, these often largely vacant properties have an owner without a vested interest in ensuring the optimal physical condition and high energy performance of the property. Thus, the industry term "zombie building" applies.

In order to attract tenants, achieve positive cash flow and increase building value, the owner of a "zombie building" must make substantial improvements. Energy efficient renovations that can qualify for large immediate EPAct tax deductions will breathe new life into these properties while improving their economic return.

Charles Goulding, Attorney/CPA, is the President of Energy Tax Savers, Inc., an interdisciplinary tax and engineering firm that specializes in the energy-efficient aspects of buildings.

Joseph Most is an Analyst with Energy Tax Savers, Inc.

Spencer Marr is an Analyst with Energy Tax Savers, Inc.

The EPAct Tax Deduction

Pursuant to Code Sec. 179D, as enacted by the Energy Policy Act (EPAct) of 2005, "zombie building" owners making qualifying energy-reducing investments can obtain immediate tax deductions of up to $1.80 per square foot.[1]

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 $0.60 per square foot for each of the three major building subsystems: lighting, HVAC (Heating, Ventilation and Air Conditioning) 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.

Zombie Buildings Explained

Commercial real estate loans generally have a shelf life of between five and seven years. When the market for commercial real estate was at its height, for the majority of the last decade, investors secured commercial loans based upon property values that have since plummeted. As those loans are becoming due, owners are consequently defaulting on them. The result is that millions of commercial property square footage is unoccupied across the country. As a result, many large commercial buildings are being foreclosed.

Because banks are not in the business of managing buildings, they either turn to professional building management firms to manage the buildings and prepare them for eventual future sale, or allow an outside investor to purchase a small portion of the debt on the property in order to get a discount at the foreclosure auction. The problem with this scenario is that the former owners stop addressing major, important improvements when they know they are headed for foreclosure. These owners are resistant to capital intensive projects. Once it is apparent to the owners that they won't be able to continue owning their property, they prefer to patch up their existing building systems just enough to get by. Complicating the matter, large buildings are complex and have their own customized systems and unique repair and performance history. This means that new building owners and managers normally come in blind and attempt to review and understand the condition of the challenge they have inherited.

One of the more prominent examples of this phenomenon in action is 100 Church Street, in Manhattan, an office space with the dubious distinction, as previously reported, of "the most unoccupied space of a completed office building in Manhattan." 600,000 square feet of that building's 1.13 million squate feet remains unoccupied. However, there has been a recent emergence of interest in renting office space there thanks in large part to the building owner's commitment to making energy retrofits, so much so that it is reported that Newsweek is close to signing a lease for 200,000 square feet.[2]

Building Repairs & Energy Code Compliance

By making major repairs to their property, "zombie building" owners position themselves to attract new tenants, increase the rent roll and thereby give new life to their troubled loans.

Previously, once a building owner made the decision to repair its property, the owner was permitted to renovate without having to meet current local building codes for energy efficiency. That's changing. For example, the recently enacted New York City Energy Conservation Code (NYCECC) requires that any additions, alterations, renovations or repairs done to any building must meet current building energy code standards. Previously, if the building repairs were done to less than 50 percent of a building's major systems then the project did not have to meet current energy code standards.

Benchmarking

Recently, five large U.S. jurisdictions, namely New York City, Washington, D.C., the State of California, Seattle and Austin have enacted building energy use benchmarking and disclosure laws. In all of these areas the owner of a building over 50,000 square feet (at the minimum) must disclose building energy use to prospective tenants.[3] Given the growing awareness of energy efficiency among tenants, it will become increasingly difficult to rent energy inefficient spaces in these jurisdictions. Mandatory building-energy-use benchmarking and disclosure gives "zombie building" owners added incentive to make energy efficient investments because tenants will be increasingly likely to sign new leases and thus lose the "zombie building" distinction.

Zombie Building Tax Opportunities

Typically a "zombie building" is lagging in one or more of the three major components of the federal EPAct legislation, those components being lighting, HVAC and building envelope. Building owners looking to access the tax deductions that are available through this program can combine retrofits in each of these three building components in order to achieve the target energy reductions.

Lighting

Lighting retrofits to fluorescent, induction and LED lighting provide the quickest economic paybacks of any energy efficient building systems upgrades. Nationally, over 40 utilities provide lighting rebates that in certain cases can be worth as much as 50 percent of installed costs or greater. When coupled with utility rebates and a lighting EPAct tax deduction, a lighting retrofit often has a less than one year economic payback.

HVAC

HVAC is the largest building energy user in office buildings. During the economic downturn many office buildings deferred large system HVAC projects that now must be addressed. One basic HVAC technology that typically generates EPAct tax incentives is chillers, typically in buildings less than 150,000 square feet. For larger buildings, the owner should consider installing a hybrid chiller, which can alternate between two fuel sources, typically natural gas and electricity, based on the fuel source that is less expensive at the present time.

Office "zombie building" owners that want to leapfrog in front of the competition should consider also installing thermal storage systems. Unlike traditional cooling systems, thermal storage systems make ice at night during off-peak hours, when rates for electricity are typically much lower, and then pump the cold water that is produced throughout the walls in order to cool the offices during the day. The EPAct tax provisions actively encourage property owners to use less power by using this or similar technology, which function to overcome the electricity price differential by capitalizing on the so-called "time of day" pricing difference. As set forth under the Electricity Section of the Energy Policy Act of 2005, each electric utility must offer all of its customers a time-based rate schedule. In addition, because thermal storage systems save so much daytime electricity use, state and local utility programs will often provide large rebates.

The accompanying chart illustrates the potential EPAct tax benefits for a few publicly disclosed previously challenged buildings:

Additional Tax Opportunities Pertaining to Zombie Buildings

Pursuant to Internal Revenue Code ("Code") Sec. 48, a tax credit or cash grant is available for the installation of qualifying energy efficient specific equipment. These credits and/or grants mainly apply to the installation of technologies including alternative energy properties, like solar P.V. or geothermal heat pumps, and therefore may only be attractive to owners in certain climate regions with appropriate environments.[4] Cash grants are particularly appealing to "zombie building" owners, since tax credits generally are of limited value to building owners that are losing money on their property. This option is exclusively made available for projects that have

Publicly Disclosed Challenged Buildings

Potential Energy Efficiency EPAct Tax Deductions

Property	Source	City	Gross Square Footage	Lighting Minimum Deduction	Maximum Deduction	HVAC Maximum Deduction	Building Envelope Maximum Deduction	Total
Vornado Realty Furniture Mart	"It's a Low Point for High Point"[1]	High Point, NC	2,000,000	$600,000	$1,200,000	$1,200,000	$1,200,000	$3,600,000
100 Church Street	"SL Green's Faith in 100 Church St"[2]	New York	1,130,000	$339,000	$678,000	$678,000	$678,000	$2,034,000
161 N Clark	"Zombie Building Close to Landing Big Tenant"[3]	Chicago	1,000,000	$300,000	$600,000	$600,000	$600,000	$1,800,000
1330 Avenue of Americas	"Macklowe Loses Manhattan Office Tower State to Otera"[4]	New York	525,000	$157,500	$315,000	$315,000	$315,000	$945,000
Ballantyne Village	"Lenders Foreclosing, Intend to Auction Off Ballantyne Village"[5]	Charlotte	165,000	$49,500	$99,000	$99,000	$99,000	$297,000
6300 West Loop	"Braun Enterprises Buys Foreclosed Bel-lair Office Building"[6]	Houston	100,000	$30,000	$60,000	$60,000	$60,000	$180,000

Citations:
1. *See* Kris Hudson, *It's a Low Point for High Point*, Wall St. J., July 28, 2010.
2. *See* A.D. Pruitt, *SL Green's Faith in 100 Church St*, Wall St. J., Dec. 2, 2009, available online at *http://online.wsj.com/article/SB10001424052748703735004574570260071216876.html.*
3. *See* Todd J. Behme, *Zombie Building Close to Landing Big Tenant*, Chi. Bus., May 19, 2010, available online at *www.chicagobusiness.com/cgi-bin/news.pl?id=38283*.
4. *See* Hui-yong Yu and David M. Levitt, *Macklowe Loses Manhattan Office Tower State to Otera,* Bloomberg, April 22, 2009, available online at *www.bloomberg.com/apps/news?pid=newsarchive&sid=aWk_9IaE4pdI&refer=home.*
5. *See* Kerry Hall Singe, *Lenders Foreclosing, Intend to Auction off Ballantyne Village, Charlotte Observer.com*, May 22, 2010, available online at *www.charlotteobserver.com/2010/05/21/1450771/lenders-foreclosing-intend-to.html*.
6. *See* Jennifer Dawson, *Braun Enterprises Buys Foreclosed Bellaire Office Building*, Hous. Bus. J., May 13, 2010, available online at *http://houston.bizjournals.com/houston/stories/2010/05/10/daily39.html*.

"begun construction" during 2009 or 2010. The U.S. Department of Treasury has recently issued guidelines in order to clarify the meaning of construction that has "begun."[5] In order to access these tax credits or cash grants careful tax planning needs to be considered.

How to Finance Energy Retrofits

The all-important question that needs to be addressed when it comes to retrofitting "zombie buildings" is how these buildings' owners can raise the money necessary to invest in energy-efficient improvements. Major vendors of energy equipment around the country are keen on the growing demand for this lending market. Many of them offer their own financing programs, whereby building owners interested in retrofitting their property qualify for an energy savings based loan. Encouragingly, several major banks and brokerage firms are in the process of establishing financial instruments specifically designed to free up cash for owners of commercial property around the country.

Conclusion

The usual goal of a "zombie building" owner is to quickly make the building as desirable to potential tenants or buyers as possible. Making energy efficient building upgrades will not only help the building become more valuable, but can provide up-front investment relief in the form of EPAct tax deductions, tax credits or cash grants, and utility rebates, and will improve the building's overall publicly disclosed energy benchmarking numbers. Increasingly, more and more outside financing aid is being made available by energy equipment vendors and lending institutions, which can further reduce the initial investment burden on the building owner. The owner of a "zombie building" may feel at times like they are in quick-sand, falling deeper and deeper into the hole with no way out in sight. However, financial recovery and property viability is a realistic expectation for those owners who are willing to engage in the EPAct tax-incentivized improvements that are described above.

Endnotes

1. Energy Policy Act (EPAct) of 2005 (P.L. 109-58).
2. See A.D. Pruitt, *SL Green's Faith in 100 Church St.*, Wall St. J. Online, Dec. 2, 2009, *http://online.wsj.com/article/SB10001424052748703735004574570260071216876.html*.
3. *See* Charles Goulding, Jacob Goldman and Joseph Most, *Using EPAct Incentives to Enhance New Mandatory Building Energy Disclosure Requirement*, Corp. Bus. Tax'n Monthly, Oct. 2010, at 11.
4. *See* Charles Goulding, Joseph Most and Spencer Marr, *The Tax Aspects of Energy Equipment Tipping Points*, Corp. Bus. Tax'n Monthly, Feb. 2011, at 13.
5. See *Payments for Specified Energy Property in Lieu of Tax Credits under the American Recovery and Reinvestment Act of 2009*," United States Department of Treasury Guidance, Mar. 2010, *www.treasury.gov/initiatives/recovery/Documents/guidance.pdf*.