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By Mark de Stefanis, Construction Cost Recovery

ETC improvements can increase cash flow & the market value of commercial real estate

If you think a Cost Segregation Study is a great way to increase cash flow then listen up. For commercial real estate owners, the Energy Tax Incentives Act of 2005 "ETIA" can help lower operating expenses, defer taxes and increase a property's market value.

Most often it starts with an aging mechanical system. The affects of time, gravity and wear and tear necessitate a replacement. The replacement offers the owner an opportunity to improve a system's efficiency and the quality of our environment. To stimulate the replacement of these ailing systems and lower greenhouse gases, the ETIA provides a gross deduction between \$0.60 to \$1.80/s/f. However, this is only the tip of the iceberg. (Unfortunately, this iceberg is melting since this temporary IRC provision is due to expire on December 31, 2007.)

Got to spend it to earn it!

This is a case where you need to spend some money to make a great deal of money.

On a Cost Segregation Study that we conducted last year on a 140,000 s/f office, our Professional Engineer noted that the chiller had met the end of its useful life. We advised the client of the benefits of upgrading to an energy efficient system and some guidance on how to take advantage of the recent incentives that were enacted under the ETIA to help ease



Mark de Stefanis

the pain. At closing, the lender withheld \$400,000 of replacement reserves for the chiller as recommended by the property condition assessment. The replacement was designed and installed and by early 2006, the project was completed.

3-Fold Benefits of the Chiller Upgrade

The system has been in place for several months and the savings generated by the new "efficient" chiller is significant and comes from three specific sources:

#1) *Increase in NOI:* The upgrade has translated into a 30% reduction in our client's energy costs. The hard dollars involved equates to an increase in annualized Net Operating Income "NOI" of \$100,000.

#2) *Section 179(D)a Deduction:*

The client was entitled to a partial deduction under Section 179D(a) which translated into \$84,000 for the current year; and

#3) *Additional Project Value:* The additional NOI of \$100,000 capped at 7.5% is equal to \$1.3 million of additional market value in the property since the property was purchased based upon a lower NOI as a result of an inefficient system.

What's Involved?

Specific criteria for obtaining the deduction centers around the efficiency of the new system or systems versus a referenced building meeting the minimum requirements as outlined under the ASREA Standard 90.1.2001. The complex calculation must be completed and certified by a Professional Engineer licensed from the state where the work is being completed. The law specifies that a property owner can qualify for either the entire \$1.80 /SF deduction, subject to total Section 179 deductions, or a partial amount thereof.

Criteria Required for the Entire Deduction of \$1.80/s/f

To qualify for the entire \$1.80/SF deduction, the owner must have a Professional Engineer certify that their plan targets all of the following improvements and will result in at least a 50% reduction in energy usage:

- Interior Lighting Systems
- Heating, Cooling, Ventilation and Hot Water Systems; and

- Building Envelope.

Criteria Required for a Partial Deduction of \$0.60/s/f

To qualify for the partial deduction of \$0.60/SF, the owner must have a Professional Engineer certify that either an interior lighting system, HVAC or building envelop program will decrease energy dependence by 16 2/3rds %.

How do I Get Started?

If your building is a candidate for a new mechanical system, lighting upgrade or façade replacement, retain a Professional Engineer that understands how to calculate the benefits associated with this deduction. Develop a plan for meeting the requirements of the IRC considering your particular budget constraints. If you are having a cost segregation completed, make sure that your consultant has a Professional Engineer that can certify the plan to unlock the benefits involved.

While I have yet to meet any landlord that looked forward to a capital expenditure, the ETIA can certainly help ease the pain, increase NOI and cash flow while providing an boost in the market value of the property.

Mark de Stefanis is president of Construction Cost Recovery, Inc., an affiliate of the IVI Companies, with offices in New York, Los Angeles, Miami, Washington, and Las Vegas. ■