Clean Tax Cuts for Commercial Real Estate

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Charrette Workshop Report Summary

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Clean tax cuts – the application of supply-side tax rate cuts to “clean” waste-reducing investments – are receiving increasing attention. The idea is that by cutting tax rates for income from clean investments (where “clean” is specifically defined), investors will be more interested in making such investments, and large amounts of private capital can be leveraged, thus accelerating clean solutions.

Clean tax cuts can potentially work in a wide variety of applications but might be particularly influential in markets where investment returns are passed on to individuals and included on individual tax returns. Commercial real estate is such a market, where individuals often invest in Real Estate Investment Trusts (REITS), limited liability corporations (LLCs) and limited liability partnerships (LLPs). In all of these structures, the returns (or losses) are passed on to the investors for inclusion on their individual income taxes. Most of these investors have substantial net worth and are interested in low tax rates, which is why we see investments made by individual investors as a prime target. Thus, commercial real estate could be an excellent place to begin the clean tax cut concept.

Commercial Real Estate

According to the 2012 Commercial Buildings Energy Consumption Survey (CBECS), there are over 5.5 million commercial buildings in the United States, totaling almost 90 billion square feet. When we look at annual commercial building energy use, about 43% of use is in buildings that are owner occupied but not government owned, 34% in leased buildings and 23% in government owned buildings. Available information indicates that between 20% and 35% of commercial building floor area is owned by REITs, LLCs and partnerships, with the upper end of this range more likely.

Energy efficiency represents a substantial investment opportunity in commercial real estate. The Rockefeller Foundation, in collaboration with Deutsche Bank, estimated that there are $72 billion worth of available upgrades in existing commercial real estate in the United States.

Options for Clean Tax Cuts in Commercial Real Estate

There are several options for using clean tax cuts to encourage energy efficiency investments in commercial real estate. We held a “charrette” workshop on March 23, 2017 at which a variety of options were discussed. Two principal clean tax cut options emerged from the discussions:

1. A reduced “clean” tax rate on individual income that derives from more efficient buildings, whether owned by individuals directly or through trusts and partnerships;

2. “Clean” expensing or accelerated depreciation on investments to improve the efficiency of commercial real estate (which tax deduction might be assignable or tradable in some circumstances).[1]

Reduced Tax Rate on Income from Efficient Buildings

The concept is that income from ENERGY STAR certified buildings will qualify for a lower tax rate, because of the public benefit of reducing waste and inefficiency. EPA’s ENERGY STAR Portfolio Manager tool can benchmark the energy efficiency of buildings on a 1-100 scale. Buildings that score 75 or higher are in the top quartile of energy performance for similar buildings, and eligible to apply for ENERGY STAR certification. A registered architect or engineer must review data, visit the building, and stamp the application. Property owners would report income qualifying for the lower tax rate on IRS K-1 forms used to report income to investors.

In addition, charrette participants suggested that the lower tax rate also be available for improvements in ENERGY STAR Portfolio Manager score of 30% or more, since for some old buildings, reaching

[1] In addition, we note that participants in the Columbia University March 6 charrette on applying clean tax cuts to green bonds suggested tax exemption for mortgage-backed securities that are backed by ENERGY STAR certified buildings.

ENERGY STAR levels will be very difficult. The lower tax rate for substantial improvement might apply for five years, but then an additional 30% savings relative to the new base (or reaching ENERGY STAR certified levels) would be needed to continue to qualify for the lower tax rate.

An appropriate "clean" tax rate might be the same tax rate as is used for long-term capital gains, conferred because of the public benefit health and environmental benefits of the investment. Currently this rate is 15% for most taxpayers but 20% for those in the highest tax bracket. Under the *Better Way* proposal put forward by the House of Representative's leadership, long-term capital gains would be taxed at half the rate of normal income. The long-term capital gains rate is well-known to investors and is substantially lower than the marginal tax rate on normal income that many of these investors pay. For a tax-payer in a 20% tax bracket (many of these investors are able to take advantage of other tax breaks), we estimate that the value of the lower tax is equal to about 20% of the cost of a typical energy-saving investment.

Clean Expensing and Accelerated Depreciation

Under current tax law, when a commercial building is built or purchased, it is depreciated over 39 years, meaning that 1/39th of this cost is treated as an expense for tax purposes each year. The same 39 year depreciation period applies to building improvements that are attached to the building, such as lighting fixtures and HVAC systems, even though this equipment has a typical equipment life of 15-20 years. This long depreciation period can be a disincentive for energy-saving investments since if inefficient equipment is replaced before 39 years, the undepreciated balance is treated as an expense in the year the equipment is replaced. One exception to this 39 period is for tenant improvements – funds provided by the owner to new tenants to fit-out their new space – these are depreciated over 15 years.

The House Republican *Better Way* plan proposes that all business investments be expensed and not depreciated. On the other hand, *Better Way* would no longer allow interest expenses to be deducted. This is an expensive provision – the Tax Policy Center estimates a 10-year cost of this provision to the federal treasury of $437 billion. Furthermore, the real estate industry does not like the provision that interest expenses are not deductible, since real estate relies on long-term financing in which interest expenses are substantial. Thus, in our view, there is a substantial chance that immediate expensing may not be included in tax reform legislation.

In this eventuality, expensing or accelerated depreciation could be used as a targeted clean tax cut, applicable just to energy efficiency investments (and potentially other clean investments). Such a provision would apply to all commercial buildings (and potentially industrial facilities), and not just to the REIT, partnership and LLC portion of the market. We estimate that for a tax-payer in a 20% marginal tax bracket, the value of expensing relative to 39-year depreciation is equal to about 13% of the cost of an investment. This would be a useful incentive for energy efficiency investments. One idea discussed at the charrette workshop is to scale the depreciation with the amount of energy savings achieved. For example, buildings achieving 30% energy savings earn immediate expensing; 20% energy savings earns 5 year depreciation, and 10% savings earns 10 year expensing. Since all of these periods are less than the current 15 year depreciation for tenant improvements, accelerated depreciation would also encourage building owners to work with tenants to improve efficiency in tenant spaces.

Finally, for both lower tax rates and accelerated depreciation, in order to also reach buildings owned by governments and non-profit organizations, charrette participants suggested that owners be allowed to assign the tax benefit to a project architect or engineer, a provision now incorporated in section 179D of the tax code (which is a tax deduction for certain energy efficiency investments).

A fuller report on clean tax cuts for commercial real estate is now being prepared. To receive a copy when it is ready, please email bstickles@aceee.org .