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Building Profits for Construction & Real Estate



Section 409A regulations are broad by design

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In 2004, Congress added Section 409A (409A) to the Internal Revenue Code (IRC) to regulate the taxation of “deferred compensation.” It generally applies to amounts deferred during 2005 or later, but, because the Internal Revenue Service (IRS) did not issue final 409A regulations until April 2007, employers have until December 31, 2008, to amend documents to revise times and forms of payment. However, the requirement that the operation of all deferred compensation arrangements must comply with 409A was not delayed and remains effective.

Why it deserves your attention

Section 409A was a consequence of the Enron debacle: Enron executives received deferred compensation shortly before the collapse, while the retirement accounts of the rank and file suffered huge losses. Congress intended 409A to prevent executives from being advantaged, but 409A goes far beyond that.

Although its genesis was an abuse occurring at a public company, 409A applies to *all* companies—large and small, public and private. Also, the deferred compensation regulated by 409A is extremely broad by design to thwart the mischief of clever professionals who would otherwise design arrangements to avoid its effects.



Why does 409A deserve the attention of every business? Because failure to comply with 409A may result in (1) deferred compensation being taxable income to the service provider at the time of vesting, with (2) the service provider owing a 20% excise tax and a higher-than-normal interest rate.

Deferred compensation is any written or unwritten arrangement that might result in compensation paid after the first year any services were performed that gave rise to such compensation. **Note:** This applies even to arrangements that provide a mandatory (not elective) delay in payment.

There are a number of exceptions, but three are most common:

- ✓ Payment is made within 2½ months after the year in which the compensation becomes vested.
- ✓ The arrangement is a stock option or stock appreciation right related to certain common stock of the service recipient; no deferral of gains is permitted, and the exercise price can never be less than fair market value on the grant date.
- ✓ The service provider is an independent contractor who provides “significant” services to more than one “unrelated” service recipient—an exception likely to be important in the construction, development and real estate industries.

Arrangements that qualify

The following are examples of written and unwritten arrangements that might give rise to deferred compensation:

- ✓ Employment, noncompete and consulting agreements, including offer letters
- ✓ Severance agreements and plans
- ✓ Separation agreements
- ✓ Bonus plans and programs
- ✓ Change-in-control agreements
- ✓ Long-term incentive programs
- ✓ Supplemental executive retirement plans
- ✓ Nonqualified 401(k) mirror plans
- ✓ 457(f) deferred compensation plans for tax-exempt and governmental entities
- ✓ Elective top-hat deferred compensation plans
- ✓ Shareholder agreements and stock purchase agreements
- ✓ Options or stock appreciation rights with an exercise price below fair market value on the grant date
- ✓ Phantom stock arrangements

Among other things, arrangements that constitute deferred compensation must be in writing and contain certain re-

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Going green? Harvest tax incentives

by John Cook & Derek Smith,
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As energy prices continue to escalate, so does America's environmental consciousness. Many real estate developers and property owners are looking into green building techniques as a way to lower monthly energy costs and protect the environment of their communities.

Using green building techniques has become increasingly popular in new residential and commercial building construction, as well as in the redevelopment of older existing properties. Green building takes place in both urban and rural markets, with the lease or sales value of these properties receiving a premium compared to conventional construction and design.

Green building is the process of designing and constructing energy-efficient buildings: they use renewable energy sources, reduce waste or pollutants, are designed with sustainable architecture, or they use one or more design or construction techniques to obtain these benefits.

The initial cost of green building can be higher than conventional construction, though it is potentially offset by long-term benefits from energy savings, reduced environmental costs and potential price premiums in the marketplace. To recognize these long-term benefits, Congress has enacted a number of tax deductions or tax credits to help defray green building costs.

Commercial building deduction

This deduction is based on building standards set by both the American Society of Heating, Refrigerating and Air Conditioning Engineers (ASHRAE) and the Illuminating Engineering Society of North America (IESNA). If you develop new or existing commercial buildings that save at least 50% of the heating and cooling energy of buildings that meet these standards, you are entitled to a tax deduction of up to \$1.80 per square foot.

For example, assume the developer of a corporate office building constructs a new 50,000-square-foot office building. The building is constructed using green technology that reduces the building's use of energy in the heating, cooling, ventilation, interior lighting, hot water systems or the building envelope.

Provided the 50% energy-savings requirement is satisfied, the developer would be entitled to a tax deduction of up to \$90,000 (\$1.80 x 50,000 square feet) in the year the building is placed in service. Ordinarily, the cost of a commercial property is depreciated over 39 years. Developers should be aware that claiming this deduction can trigger ordinary income upon the sale of the building.

To obtain the tax deduction, a qualified contractor or engineer must certify the building. The energy-efficient commercial building deduction generally applies to

buildings placed in service before December 31, 2008.

Energy-efficient home credit

Homebuilders are eligible for a \$2,000 tax credit per home for the construction of qualified new energy-efficient residential homes. The credit is available for homes that achieve a 50% energy savings for heating and cooling over the 2004 Supplement to the 2003 International Energy Conservation Code (IECC).

At least a fifth of the energy savings must come from building envelope improvements, *e.g.*, basement walls, exterior walls, floor, roof and other similar components. For the homebuilder to be eligible for the credit, the home must be acquired by an individual for use as a residence.

In addition, the credit is available for substantial reconstruction or rehabilitation of existing homes. To be eligible for the credit, the homebuilder must receive certification the home meets energy-saving requirements.

The credit is available for homes acquired from the eligible homebuilder for use as a residence through December 31, 2008. Depending on the energy-efficiency level, manufactured homes are also eligible for a per-home credit up to \$2,000.

Tax credits for homeowners

Tax credits are available to homeowners

Global warming heats up incentives to build green

by John Cook, jcook@bkd.com

In the fight against global warming, buildings receive a lot of attention because they annually account for 39% of U.S. energy use. According to the U.S. Green Building Council (USGBC) (see usgbc.org), carbon dioxide emissions could be cut six-million tons a year (the equivalent of taking one million cars off the road) if half of the country's new commercial buildings used 50% less energy.

Guidelines from the National Association of Home Builders (NAHB) encourage environmentally sound build-

ing practices, from site design to construction materials. According to an NAHB-member survey, "about 10% of new homes will be green" by 2010.

Incentives target energy use

In the meantime, buildings annually account for the following:

- ✓ 39% of U.S. primary energy use
- ✓ 70% of U.S. resource consumption
- ✓ 15 trillion gallons of water use
- ✓ 136 million tons of construction and demolition debris

According to the USGBC, "many de-

velopers are building more energy-efficient buildings on their own." Under its Leadership in Energy and Environmental Design (LEED) program, the USGBC has certified close to 900 buildings, with 6,500 projects awaiting certification.

Many in the industry believe new and better incentives will continue to be introduced. For example, the USGBC reports some localities "offer tax breaks, expedited permitting and density bonuses to developers of LEED-certified projects." Going green may not work for all projects, but incentives can benefit the ones it does. ■

along the way

ers for a wide array of home improvements where specific energy-saving products are installed, including exterior windows, skylights, storm doors, exterior doors, certain metal roofs, insulation, energy-efficient heating and air conditioning systems and water heaters.

The credit is generally 10% of the cost of the product and is subject to a maximum amount depending on the type of product installed. The maximum credit for every improvement combined is limited to \$500 over the two-year period and applies to qualifying home improvements made to a primary residence from January 1, 2006, through December 31, 2007.

To be eligible, homeowners must generally obtain a manufacturer's certification that the product or component used in the home improvement qualifies for the credit.

Qualified solar water-heating and photo-voltaic systems also qualify for tax credits if placed in service from January 1, 2006, through December 31, 2008. The credit is 30% of the cost of the system, capped at a maximum of \$2,000 for each type of system. **Note:** No part of the solar water-heating or photo-voltaic systems can be used to heat a pool or hot tub.

Installing a qualified fuel cell and microturbine system also qualifies for a tax credit of up to 30% of the cost of the system, capped at \$500 for each .5 kilowatt of capacity. Generally, a qualified fuel-cell power plant:

- ✓ Electrochemically converts fuel into electricity
- ✓ Has an electricity-only generation efficiency of more than 30%
- ✓ Generates at least .5 kilowatts of electricity

Green building incentives

If you are a developer or homeowner, take an overall project approach to green building. Consider every aspect of the development: financial cost, long-term energy savings, potential tax incentives or rebates, climate zone, positioning of the building and waste-water management, among numerous other factors.

By evaluating the entire project as a system, it will help you determine the best energy-saving strategies for financial and environmental conservation. Depending

on your specific project, it may make sense to consider the availability of tax credits or deductions to help reduce the upfront cost of your project.

However, many current federal tax incentives require a third-party certification process; carefully weigh its cost against the potential tax benefits. Federal legislators have shown increased interest in providing incentives to green builders, so additional

TIF can make blighted areas more attractive to developers

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It may seem too good to be true, but, under certain conditions, it's possible to finance a portion of your development costs with future real estate tax revenues collected by the government.

As an area prospers economically, state and local governments know tax revenues generated from the area will also increase—be they property taxes, sales taxes or any other type of tax. State and local governments use this as a way to induce businesses to relocate, rehabilitate or develop economically blighted areas.

The exact type of inducement can vary from contributing land and property to providing financial assistance. One such inducement of particular interest to developers is tax-increment financing (TIF).

How a TIF works

The TIF concept is relatively simple: A local government advances a business cash (typically in the form of a loan) to develop or rehabilitate an area designated as economically blighted. Any additional tax revenues generated as a result of the development project are used to reduce the loan's principal and interest.

Generally, the amount of tax revenues generated from the economically blighted area are measured the year before the TIF project is placed in service. In subsequent years, any tax revenue generated over and above the measured base is used to reduce the TIF loan.

incentives may be on the horizon.

In addition, states are beginning to enact green building legislation to provide tax incentives that may also benefit developers and homeowners. Many federal tax incentives are only available for a limited number of years, so, if you're considering building your next project green, it's important to leverage these incentives before they expire. ■



As stated, TIF funds are available to businesses looking to relocate, renovate or develop an economically blighted area. To be considered "economically blighted," some states require an 11-factor test be applied to the area, which includes:

- ✓ An assessment of the area's sanitary conditions
- ✓ The amount of structural deterioration in the area (or building)
- ✓ Whether conditions exist that endanger life or property
- ✓ An assessment of environmental contamination levels

Test results help cities decide whether to designate an area for urban redevelopment and advance TIF funds, which are raised in myriad ways. Often, municipal bonds are issued and the proceeds are loaned to a developer to assist with capital requirements. In this case, the incremental tax revenues generated by the project are used to make principal and interest payments on such bonds.

Alternatively, TIF money can be given to developers incrementally as the local taxing authority receives it. In this case, TIF money alleviates the development's debt burden as the project pays off its long-term debt.

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Section 409A regulations are broad . . .

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quired provisions. In addition, any deferrals of compensation or changes in payment dates must meet strict election timing requirements; this applies to elections by either the service provider or recipient. Deferred compensation is required to be paid only upon certain events or times.

How to handle violations

Examples that might involve 409A violations include:

- ✓ Extending stock option exercisability for severed employees
- ✓ Retaining discretion to accelerate or delay compensation

- ✓ Failure to delay by six months, severance pay to key employees of public companies

There is currently no procedure to fix a 409A violation, and the service recipient is required to report the violation to the IRS on the applicable W-2 or 1099. Therefore, we recommend immediate consideration of the following:

- ✓ Identify all arrangements to which 409A might apply
- ✓ Identify the best alternatives for satisfying 409A

To comply with 409A, amend all covered arrangements by December 31, 2008,

and obtain (by December 31, 2008) any new payment elections offered to anyone deferring compensation.

Contact your legal counsel and your BKD advisor for more information or to help you determine if any arrangements you have will give rise to deferred compensation.

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TIF makes blighted areas more attractive. . .

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How developers can benefit

From a developer's standpoint, TIF money provides multiple benefits:

- ✓ Bridges any capital shortfall a developer may have; however, a TIF cannot be used to finance an entire project
- ✓ Reduces a project's debt burden because TIF funds are repaid by taxes—either in whole or in part—which can significantly enhance a project's financial viability
- ✓ Under certain conditions, TIF money

can qualify as nontaxable receipts

- ✓ TIF-financed projects generally enjoy broad-based support from both local government and area residents

The TIF concept has been around for years. The financial structure of many prominent development properties have included TIF funds. Consider TIF if you're contemplating a rehabilitation or new development project. If properly structured, it can provide a win-win-win situation for the municipality, the developer and the community. ■

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