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[*1]

SUBJECT MATTER: Section 179D deduction and certain partnerships and S corporations

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TEXT:

This memorandum addresses the application of the § 179D deduction to certain partnerships and S corporations. This document may not be used or cited as precedent.

ISSUES

Where a government entity allocates a § 179D deduction for energy efficient commercial buildings to a partnership or S corporation "designer" pursuant to § 179D (d) (4):

1. Are the partners or shareholders of the designer required to reduce the adjusted bases in their partnership interests or S corporation stock by the amount of the § 179D deduction?
2. Do the provisions of §§ 704 (d) and 1366 (d) limit the benefit of the § 179D deduction to the partners or shareholders' adjusted bases in their partnership interests or S corporation stock?

CONCLUSIONS

1. The partners or shareholders of the designer must [*2] reduce the adjusted bases in their partnership interests or S corporation stock by the amount of the § 179D deduction.

2. Sections 704 (d) and 1366 (d) limit the benefit of the § 179D deduction to the partners or shareholders' adjusted bases in their partnership interests or S corporation stock.

LAW AND ANALYSIS

Section 179D provides a deduction for part or all of the cost of energy efficient commercial building property that a taxpayer places in service after December 31, 2005, and before January 1, 2014. The § 179D deduction shall not exceed the excess (if any) of (i) the product of \$1.80 and the square footage of the building, over (ii) the aggregate amount of § 179D deductions allowed with respect to the building for all prior taxable years if it reduces the total annual energy and power costs with respect to combined usage of the building's heating, cooling, ventilation, hot water, and interior lighting systems by 50 percent or more as compared to a Reference Building that meets the minimum requirements of Standard 90.1-2001. If the property fails to qualify for the maximum § 179D deduction, § 179D (d) (1) provides for a partial allowance of up to \$.60 rather than \$1.80 per square [*3] foot for each system meeting the requirements for a partial deduction. See Notice 2006-52, 2006-1 C.B. 1175, for an explanation of the computation of the § 179D deduction.

Section 179D (d) (4) provides that in the case of energy efficient commercial building property that is installed on or in property owned by a Federal, State, or local government or a political subdivision thereof, the Secretary shall promulgate a regulation to allow the allocation of the § 179D deduction "to the person primarily responsible for designing the property [the designer] in lieu of the owner of such property." A designer is a person that creates the technical specifications for installation of energy efficient commercial building property for which a deduction is allowed under § 179D. A person that merely installs, repairs, or maintains the property is not a designer.

The § 179D deduction will be allowed to the designer for the taxable year that includes the date on which the property is placed in service. A designer may not claim a § 179D deduction in excess of the amount of the costs incurred by the owner of the government-owned building to place the energy efficient commercial building property in service. [*4] The designer does not include any amount in income on account of the § 179D deduction allocated to them and the designer is not required to reduce future deductions by an amount equal to the § 179D deduction allocated to them. See Notice 2008-40, 2008-14 I.R.B. 725, for further rules regarding the allocation provision of § 179D (d) (4).

Many of the designers that receive allocations of the § 179D deduction under § 179D (d) (4) are organized as partnerships or S corporations for federal tax purposes. These firms often distribute the majority of their net income to their partners or shareholders at the end of each taxable year, as architectural and design firms typically require minimal capital to operate. This practice results in the partners and shareholders having minimal bases in their ownership interests in the designer entities.

Section 704 (d) provides that a partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end

of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end [*5] of the partnership year in which such excess is repaid to the partnership.

Section 705 (a) provides that the adjusted basis of a partner's interest in a partnership shall be (1) increased by the sum of his distributive share of (A) taxable income of the partnership as determined under section 703 (a), (B) income of the partnership exempt from tax, and (C) certain excess depletion deductions, and (2) decreased (but not below zero) by the sum of his distributive share of (A) losses of the partnership, and (B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.

Section 731 (a) provides that in the case of a distribution by a partnership to a partner, gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.

Section 733 provides that in the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by (1) the amount of any [*6] money distributed to such partner, and (2) the amount of the basis to such partner of distributed property other than money.

Section 1366 (d) provides that the aggregate amount of losses and deductions taken into account by an S corporation shareholder cannot exceed the sum of the adjusted basis of the shareholder's stock in the S corporation and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder. *Section 1366 (d) (2)* provides for the indefinite carryover of disallowed losses and deductions.

Section 1367 (a) provides that the basis of each shareholder's stock in an S corporation shall be (1) increased by the sum of (A) items of income described in § 1366 (a) (1) (A), (B) any nonseparately computed income determined under § 1366 (a) (1) (B), and (C) certain excess depletion deductions, and (2) decreased (but not below zero) by the sum of (A) distributions not includible in income by reason of § 1368, (B) items of loss and deduction described in § 1366 (a) (1) (A), (C) any nonseparately computed loss determined under § 1366 (a) (1) (B), (D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable [*7] to capital account, and (E) certain deductions for oil and gas depletion.

Section 1368 (b) provides that a distribution of property made by an S corporation with no accumulated earnings and profits shall, to the extent that it exceeds the adjusted basis of the stock, be treated as gain from the sale or exchange of property. 1

In the case of a designer that is a partnership or S corporation, the partners or shareholders typically have insufficient bases in their ownership interests to absorb any ordinary loss generated by the § 179D deduction. We understand that a growing number of taxpayers (both design firms and their individual partners or shareholders) have taken the position that this deduction is available to the partners or shareholders without regard to the basis limitation rules contained in §§ 704 (d) and 1366 (d), either on the theory that the deduction is a partner or shareholder level deduction, or because the basis limitations of §§ 704 (d) and 1366 (d) and basis adjustment rules of §§ 705 (a) and 1367 (a) simply do not apply with respect to the § 179D deduction.

If a government entity hires a designer to perform work on energy efficient commercial building property, and [*8] that designer is organized as a partnership or S corporation, the contract for services runs between the government entity and the partnership or S corporation, regardless of which individual members of the partnership or S corporation personally perform the services under the contract. If the government entity allocates a deduction to the designer pursuant to § 179D (d) (4), it is the partnership or S corporation that receives the allocation of the § 179D deduction allocation. Although certain deductions of a partnership or S corporation may be claimed directly by its partners or shareholders, in those instances, there exists explicit authority providing for such a result. For example, § 199 (d) (1) specifically provides that, with respect to partnerships and S corporations, the deduction available under that section applies "at the partner or shareholder level." However, no such language exists with respect to the deduction allowed under § 179D. Absent

such authority, the deduction under § 179D, like any other partnership or S corporation item of deduction, is used to calculate the entity's ordinary income or loss. Each partner or shareholder's share of that income or loss requires [*9] an adjustment to the partners or shareholders' bases in their ownership interests under §§ 705 (a) or 1367 (a), and the partners or shareholders' ability to claim any ordinary loss generated by the deduction is limited to the basis in their ownership interest under §§ 704 (d) or 1366 (d).

Example 1 - § 704 (d) limitation and § 731 gain: A, B, and C form a partnership (ABC Partnership) to design a 100,000 square foot energy efficient office building that will be owned by State government. Each partner has a zero basis in his partnership interest. The partnership agreement provides that all allocations and distributions of ABC Partnership are to be made equally among A, B, and C.

State pays ABC Partnership \$120,000 for its services and pays a third-party builder \$160,000 to construct the building, thus paying \$280,000 for the entire cost of the project. The project meets the energy efficiency requirements to receive a maximum § 179D deduction equal to the product of \$1.80 and the square footage of the building. State allocates the entire § 179D deduction of \$180,000 to ABC Partnership under § 179D (d) (4). After applying the deduction, ABC Partnership will recognize an ordinary loss of [*10] \$60,000 for the year (\$120,000 of gross income less \$180,000 of § 179D deduction), to be allocated equally among A, B, and C. As a result, the basis of each of A, B, and C's interests in ABC Partnership remains zero. At the end of the year, ABC Partnership distributes the \$120,000 of cash it received from State equally to A, B, and C, or \$40,000 to each. Because A, B, and C have zero bases in their ABC Partnership interests prior to the distribution, the entire \$40,000 distributed to each of A, B, and C will be considered a taxable gain from the sale or exchange of property. In addition, neither A, B, nor C can take into account their \$20,000 distributive share of ordinary loss under § 704 (d).

Example 2- § 731 gain: The facts are the same as in Example 1, except that State pays ABC Partnership \$300,000 for its services. ABC Partnership's gross income of \$300,000 is partly offset by the § 179D deduction of \$180,000. Thus, ABC Partnership will recognize \$120,000 in ordinary income for the year, to be allocated equally among A, B, and C. A, B, and C will increase the basis in their ABC Partnership interests by their distributive shares of that income, or \$40,000 each. At the end of the [*11] year, ABC Partnership distributes the \$300,000 of cash it received from State to A, B, and C according to the partnership agreement, or \$100,000 each. Because the basis of each of A, B, and C's ABC Partnership interests is \$40,000 prior to the distribution, \$60,000 of the \$100,000 distributed to each of A, B, and C will be considered a taxable gain from the sale or exchange of property.

Example 3 - § 1368 gain and 1366 limitation: X, Y, and Z form an S corporation (XYZ Corp.) to design an energy efficient expansion to a 200,000 square foot school that is owned by County government. Each shareholder has a zero basis in the stock and an equal 1/3 ownership interest in XYZ Corp. XYZ Corp. has no accumulated earnings and profits.

County pays XYZ Corp. \$90,000 for its design services and pays a third party builder \$150,000 to construct the expansion, thus paying \$260,000 for the entire cost of the project. The project meets the energy efficiency requirements to qualify for a partial § 179D deduction for the building envelope installed as part of the project, of no greater than the product of \$0.60 and the square footage of the entire building. County allocates the partial § 179D deduction [*12] of \$120,000 to XYZ Corp. under § 179D (d) (4). After applying the deduction, XYZ Corp. will recognize an ordinary loss of \$30,000 for the year (\$90,000 of gross income -\$150,000 of § 179D deduction). As a result, the basis of each of X, Y, and Z's stock in XYZ

Corp. remains zero. At the end of the year, XYZ Corp. distributes the \$90,000 of cash it received from County to X, Y, and Z in proportion to their ownership interests, or \$30,000 each. Because X, Y, and Z have zero bases in their XYZ Corp. stock prior to the distribution, the entire \$30,000 distributed to each of X, Y, and Z will be considered a taxable gain from the sale or exchange of property. In addition, neither X, Y, nor Z can take into account their proportionate \$10,000 amount of ordinary loss under § 1366.

Example 4 - § 1368 gain: The facts are the same as in Example 3, except that County pays XYZ Corp. \$150,000 for its design services and pays a third party builder \$200,000 to construct the expansion, thus paying \$350,000 for the entire cost of the project. County allocates the partial § 179D deduction of \$120,000 to XYZ Corp. under § 179D (d) (4). XYZ Corp.'s gross income of \$150,000 is partially offset by the § 179D [*13] deduction of \$120,000, and XYZ Corp. therefore will recognize \$30,000 in ordinary income for the year. At the end of the year, XYZ Corp. distributes the \$150,000 of cash it received from County to X, Y, and Z in proportion to their ownership interests, or \$50,000 each. X, Y, and Z will increase the bases in their XYZ Corp. stock by their proportionate amounts of the ordinary income, giving them each a \$10,000 basis in their XYZ Corp. stock prior to the distribution. As a result, \$40,000 of the \$50,000 distributed to each of X, Y, and Z will be considered a taxable gain from the sale or exchange of property.

Please call (202) 622-3050 if you have any further questions on this matter. For information regarding other issues arising under § 179D, please call (202) 622-3110.

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FOOTNOTES:

1 Section 1368 (c) provides rules for determining the treatment of distributions made by an S corporation with accumulated earnings and profits. For purposes of this memorandum we are focusing on S corporations without accumulated earnings and profits.