

Are you missing out on deductions for your commercial building?

Legislative History

Section 179D was originally established by the Energy Policy Act of 2005. It has currently been extended for five years through 2013 by the Emergency Economic Stabilization Act of 2008. The IRS has published Notice 2006-52 to provide technical details concerning the deduction and its use.

Present Law

A deduction is allowed for all or part of the cost of energy-efficient commercial building property (i.e., certain major energy-savings improvements made to domestic commercial buildings) placed in service after December 31, 2005 and before January 1, 2014. The deduction is claimed on the "Other deductions" line of the tax return. There is no special form for computing the deduction.

To qualify as energy efficient commercial building property, the property must be:

- (1) Depreciable (that is, capitalizable) and installed as part of:
 - the interior lighting systems;
 - the heating, cooling, ventilation, or hot water systems; or
 - the building envelope and
- (2) certified by a qualified professional to reduce total annual energy and power costs of the building's heating, cooling, ventilation, hot water, and interior lighting systems by 50 percent or more when compared to a similar reference building that meets minimum specified energy standards.

The certification statement does not include a calculation of the tax deduction and is not included with the taxpayer's return.

The maximum cost of energy-efficient commercial building property that may be deducted in any tax year is limited to the lesser of: (1) the cost of the energy-efficient commercial building property placed in service during the tax year or (2) the product of \$1.80 and the square footage of the building, reduced by all deductions claimed with respect to the building in any prior tax years.

If the overall 50 percent energy reduction standard is not satisfied, but improvements to one of the three energy-efficient commercial building property types described in (1) above reduce energy usage by $16\frac{2}{3}$ percent, then the cost of the improvements to that particular subsystem (referred to as partially qualifying property) may also be deducted in the tax year placed in service, but the cost that is deducted is limited to 60 cents per square foot of building space less total deductions claimed under Code Sec. 179D in prior tax years.

A building envelope is also treated as partially qualifying property if the envelope will reduce overall energy usable by at least 10 percent. However, if a taxpayer takes advantage of this lower threshold for the definition of a partially qualifying building envelope, the otherwise applicable $16\frac{2}{3}$ percent energy savings thresholds that apply to qualify as partially qualifying energy-efficient lighting property under the permanent rule and partially qualifying energy-efficient heating, cooling, ventilation, and hot water property are increased to 20 percent.

Who claims deduction? The deduction is claimed by the person who is entitled to depreciate the property (e.g., the owner of the building or a lessee who pays for and installs the property). However,

in the case of a federal, state, or local government building, the person who designs the energy-efficient commercial building property may claim the deduction. Improvements to a tax-exempt property (other than a government building), such as a church, which is not depreciable, do not qualify for the deduction. Improvements to a residential rental building qualify for the deduction if it has four or more stories above ground level.

Basis reduction. The basis of any property generating a deduction must be reduced by the amount deducted. Thus, for example, the basis is reduced for purposes of computing depreciation or determining gain or loss.

Depreciation recapture. Deductions claimed for energy-efficient commercial building property under Code Sec. 179D are subject to recapture under the Code Sec. 1245 recapture rules. This means that gains on the sale of the property are treated as ordinary income to the extent of the deduction allowed.

Example 1

A Company decided to improve the lighting in its 70,000 square foot factory building and spent \$60,000 on qualifying new, energy-efficient lighting fixtures. The Company has not claimed any Section 179D deductions in prior years. The Company can claim an immediate deduction of \$42,000 (70,000 sq. ft. x \$.60 per square foot). The remaining \$18,000 of money spent can be written off over normal depreciation methods and lives.

Example 2

A business decides to build a new energy-efficient 40,000 square foot distribution facility. It spends \$4,000,000 on the new building envelope and the rest of the infrastructure. The Company will be able to claim an upfront Section 179D deduction in the year the building is placed in service of \$72,000 (40,000 sq. ft. x \$1.80 per square foot). The remaining basis will be able to be depreciated over normal real property depreciation methods and lives. As an aside, the Company may wish to obtain a cost segregation study to further break down the cost of the building into its components which would allow it to write off these amounts over 5, 7, 15, and 39 years.

Example 3

If the property in Example 2 is sold for \$5,500,000 and the net book value is \$2,928,000 with 179D deduction of \$72,000 and other depreciation of \$1,000,000, the gain of \$2,572,000 would be taxed as follows:

179D	\$ 72,000	ordinary income rate
1250	\$1,000,000	gain at 25%
1231	\$1,500,000	gain at 15%

Our Real Estate Group can help you understand the tax benefits of this energy-efficient deduction. Please contact us if you have any questions.