



March, 2006

## **DEDUCTION FOR ENERGY EFFICIENT COMMERCIAL BUILDING PROPERTY**

In August 2005 Congress passed and the President signed The Energy Tax Incentives Act of 2005. Included in that Act was new Code Section 179D entitled, Energy Efficient Commercial Buildings Deduction (see attached Internal Revenue Code Section 179D).

Under Section 179D a deduction is allowed in an amount equal to the cost of energy efficient commercial building property (defined below) placed in service during the tax year. The deduction for any building for any tax year cannot exceed the excess (if any) of the product of \$1.80, and the square footage of the building, over the aggregate amount of the deduction under this section for the building for all earlier tax years.

The deduction will not apply for property placed in service after Dec. 31, 2007.

This deduction applies for a two-year period for property placed in service between Jan. 1, 2006 and Dec. 31, 2007.

### **ENERGY EFFICIENT COMMERCIAL BUILDING PROPERTY IS PROPERTY:**

- a. for which depreciation or amortization is allowable,
- b. which is installed on or in a building located in the U.S., and within the scope of Standard 90.1-2001 (defined below),
- c. which is installed as part of the interior lighting systems, the heating, cooling, ventilation, and hot water systems, or the building envelope,
- d. which is certified, under the procedures described below, as being installed as part of a plan designed to reduce the total annual energy and power costs for the interior lighting, heating, cooling, ventilation, and hot water systems of the building by 50% or more in comparison to a reference building that meets the minimum requirements of Standard 90.1-2001, using methods of calculation described below.

Standard 90.1-2001 means Standard 90.1-2001 of the American Society of Heating, Refrigerating and Air Conditioning Engineers and the Illuminating Engineering Society of North American (ASHRAE/IESNA) (as in effect on April 2, 2003).

The IRS, in consultation with the Secretary of Energy, must issue regulations describing in detail the methods for calculating and verifying energy and power consumption and cost, taking into consideration the provisions of the 2005 California Nonresidential Alternative Calculation Method Approval Manual (2005 ACM Manual).

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Any energy or power cost savings calculation must be prepared by "qualified computer software". "Qualified computer software" is software that:

- the software designer has certified meets all procedures and detailed methods for calculating energy and power consumption and costs as the IRS requires;
- provides the forms that the IRS requires to be filed in connection with the energy efficiency of property and the deduction for energy efficient commercial building property; and
- provides a notice form that summarizes the energy efficiency features of the building and its projected annual energy costs.

Congress intends that the methods for calculation be fuel neutral, so that the same energy efficiency will qualify a building for the deduction whether the heating source is gas or oil, furnace or boiler, or an electric heat pump. Congress also intends that these calculation methods must provide appropriate calculated energy savings for design methods and technologies not otherwise credited in either Standard 90.1-2001 or in the 2005 ACM Manual, including the following:

1. natural ventilation,
2. evaporative cooling,
3. automatic lighting controls such as occupancy sensors, photocells and time clocks,
4. daylighting,
5. designs using semi-conditioned spaces which maintain adequate comfort conditions without air conditioning or heating,
6. improved fan system efficiency, including reductions in static pressure,
7. advanced unloading mechanisms for mechanical cooling, such as multiple or variable speed compressors,
8. on-site generation of electricity, including combined heat and power systems, fuel cells, and renewable energy such as solar, and
9. wiring with lower energy loss than wiring satisfying Standard 90.1-2001 requirements for building power distribution systems

Also, the calculation methods may take into account the extent of commissioning in the building, and allow the taxpayer to take into account measured performance that exceeds typical performance.

## **PUBLIC BUILDINGS**

If energy efficient commercial building property is installed on or in property owned by a federal, state, or local government, or a subdivision of one, the IRS must issue a regulation allowing the deduction to be allocated to the person primarily responsible for designing the property, instead of the owner of the property. For purposes of taking the energy efficient commercial building property deduction, the person primarily responsible for designing the property is treated as the taxpayer. Property owned by a public entity includes schools.

**PARTIAL ALLOWANCE OF DEDUCTION (Refer to Code Section 179D attached)**

Except as provided in Code Sec. 179D(f)(concerning reductions of lighting power density of a building of less than 40%, see below) if the requirement of Code Sec. 179D(c)(1)(D) that the property be certified as reducing total annual energy and power costs by 50% or more (see above) is not met, but there is a certification (as described below) that any system referred to in Code Sec. 179D(c)(1)(C) (lighting, heating, cooling, ventilation, hot water, building envelope) satisfies the energy-savings targets the IRS established under Code Sec. 179D(d)(1)(B) (see below) for that system, then the requirement of Code Sec. 179D(c)(1)(D) is treated as met for that system, and the deduction under Code Sec. 179D(a) is allowed for energy efficient commercial building property installed as part of that system and as part of a plan to meet those targets, except that Code Sec. 179D(b)(related to the maximum amount of the deduction, as discussed above) is applied to the property by substituting \$.60 for \$1.80.

After consultation with the Secretary of Energy, the IRS must establish a target for each system described in Code Sec. 179D(c)(1)(C) which, if the targets were met for all those systems, would be equivalent to a target which meets the requirements of Code Sec. 179D(c)(1)(D).

Congress explains that in the case of a building that does not meet the overall building requirement of 50% energy savings, a partial deduction is allowed for each separate building system that comprises energy efficient property and that is certified by a qualified professional as meeting those system-specific targets the IRS has established. Those system-specific targets are those that would result in a total annual energy savings of 50% for the whole building if each of the separate systems met the systems-specific target. The separate systems are (1) interior lighting, (2) heating, cooling, ventilation and hot water, and (3) the building envelope.

**PARTIAL DEDUCTION FOR LIGHTING SYSTEMS UNTIL THE IRS ISSUES REGULATIONS**

When IRS issues final regulations under Code Sec. 179D(d)(1)(B) (concerning partial deduction targets, see above) for property that is part of a lighting system, the lighting system target for purposes of the partial deduction under Code Sec. 179D(d)(1)(A)(ii) is a reduction in lighting power density of 25% (50% in the case of a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 (not including additional interior lighting power allowances) of Standard 90.1-2001.

For the lighting system of any building other than a warehouse, if the reduction of lighting power density of the lighting system is not at least 40%, only the "applicable percentage" of the amount of deduction otherwise allowable under Code Sec. 179D for the property is allowed. The applicable percentage is the number of percentage points (not greater than 100) equal to the sum of 50, and the amount which bears the same ratio to 50 as the excess of the reduction of lighting power density of the lighting system over 25 percentage points bears to 15.

Thus, although, in the case of system-specific partial deductions, generally no deduction is allowed until the IRS establishes system-specific targets (see "Partial allowance of deduction", above), in the case of certain lighting systems, until the IRS issues final regulations, a pro-rated partial deduction is allowed for a lighting system that reduces lighting power density between 25% and 40%.

The interim rules for lighting systems do not apply to any system the controls and circuiting of which do not comply fully with the mandatory requirements of Standard 90.1-2001 and which do not include provision for bi-level switching in all occupancies except hotel and motel guest rooms, store rooms, restrooms, and public lobbies, or which does not meet the minimum requirements for calculated lighting levels as set forth in the Illuminating Engineering Society of North America Lighting Handbook, Performance and Application, Ninth Edition, 2000.

The IRS must issue regulations to provide for a recapture of the deduction allowed under Code Sec. 179D if the plan is not fully implemented.

The IRS must also issue regulations as necessary to take into account new energy efficiency and renewable energy technologies for purposes of determining energy efficiency and savings under Code Sec. 179D.

### **CERTIFICATION REQUIRED**

The IRS must prescribe the manner and method for making certifications under Code Sec. 179D. As part of the certification process, the IRS must include procedures for inspection and testing by "qualified individuals" (defined below) to ensure compliance of buildings with energy-savings plans and targets. These procedures must be comparable, given the difference between commercial and residential buildings, to the requirements in the Mortgage Industry National Accreditation Procedures for Home Energy Rating Systems. Each certification must provide an explanation to the owner of the building ("Notice to owner") of the energy efficiency features of the building and its projected annual energy costs.

Individuals who are qualified to determine compliance can be only those individuals who are recognized by an organization the IRS has certified for that purpose.

### **BASIS**

If a deduction is allowed under Code Sec. 179D for energy efficient commercial building property, the basis of the property must be reduced by the amount of the deduction allowed.

The depreciation recapture rules under Sec. 1245 are applicable to energy efficient commercial building property deductions under Code Sec. 179D.

### **PRIOR LAW**

For property placed in service before Jan. 1, 2006 there was no deduction for energy efficient commercial building property and none of the provisions above were in effect.

### **TAX ADVICE**

Each taxpayer who seeks to claim a deduction under this section should seek competent tax advice and refer to the regulations to be issued before proceeding.

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**QUESTIONS**

Any questions on the above may be directed to Beth Feuchtenberger or Richard Auld at Eide Bailly LLP in Sioux Falls, South Dakota at 605-339-1999.

## § 179D Energy efficient commercial buildings deduction.

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**(a) In general.**

There shall be allowed as a deduction an amount equal to the cost of energy efficient commercial building property placed in service during the taxable year.

**(b) Maximum amount of deduction.**

The deduction under subsection (a) with respect to any building for any taxable year shall not exceed the excess (if any) of—

(1) the product of—

(A) \$1.80, and

(B) the square footage of the building, over

(2) the aggregate amount of the deductions under subsection (a) with respect to the building for all prior taxable years.

**(c) Definitions.**

For purposes of this section —

**(1) Energy efficient commercial building property.**

The term "energy efficient commercial building property" means property—

(A) with respect to which depreciation (or amortization in lieu of depreciation) is allowable,

(B) which is installed on or in any building which is—

(i) located in the United States, and

(ii) within the scope of Standard 90.1-2001,

(C) which is installed as part of—

(i) the interior lighting systems,

(ii) the heating, cooling, ventilation, and hot water systems, or

(iii) the building envelope, and

(D) which is certified in accordance with subsection (d)(6) as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building which meets the minimum requirements of Standard 90.1-2001 using methods of calculation under subsection (d)(2) .

**(2) Standard 90.1-2001.**

The term "Standard 90.1-2001" means Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America (as in effect on April 2, 2003).

**(d) Special rules.**

**(1) Partial allowance.**

(A) In general. Except as provided in subsection (f) , if—

(i) the requirement of subsection (c)(1)(D) is not met, but

(ii) there is a certification in accordance with paragraph (6) that any system referred to in subsection (c)(1)(C) satisfies the energy-savings targets established by the Secretary under subparagraph (B) with respect to such system,

then the requirement of subsection (c)(1)(D) shall be treated as met with respect to such system, and the deduction under subsection (a) shall be allowed with respect to energy efficient commercial building property installed as part of such system and as part of a plan to meet such targets, except that subsection (b) shall be applied to such property by substituting "\$.60" for "\$1.80".

(B) Regulations. The Secretary, after consultation with the Secretary of Energy, shall establish a target for each system described in subsection (c)(1)(C) which, if such targets were met for all such systems, the building would meet the requirements of subsection (c)(1)(D) .

**(2) Methods of calculation.**

The Secretary, after consultation with the Secretary of Energy, shall promulgate regulations which describe in detail methods for calculating and verifying energy and power consumption and cost, based on the provisions of the 2005 California Nonresidential Alternative Calculation Method Approval Manual.

**(3) Computer software.**

(A) In general. Any calculation under paragraph (2) shall be prepared by qualified computer software.

(B) Qualified computer software. For purposes of this paragraph, the term "qualified computer software" means software—

(i) for which the software designer has certified that the software meets all procedures and detailed methods for calculating energy and power consumption and costs as required by the Secretary,

(ii) which provides such forms as required to be filed by the Secretary in connection with energy efficiency of property and the deduction allowed under this section , and

(iii) which provides a notice form which documents the energy efficiency features of the building and its projected annual energy costs.

**(4) Allocation of deduction for public property.**

In the case of energy efficient commercial building property 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 deduction to the person primarily responsible for designing the property in lieu of the owner of such property. Such person shall be treated as the taxpayer for purposes of this section .

**(5) Notice to owner.**

Each certification required under this section shall include an explanation to the building owner regarding the energy efficiency features of the building and its projected annual energy costs as provided in the notice under paragraph (3)(B)(iii) .

**(6) Certification.**

(A) In general. The Secretary shall prescribe the manner and method for the making of certifications under this section .

(B) Procedures. The Secretary shall include as part of the certification process procedures for inspection and testing by qualified individuals described in subparagraph (C) to ensure compliance of buildings with energy-savings plans and targets. Such procedures shall be comparable, given the difference between commercial and residential buildings, to the requirements in the Mortgage Industry National Accreditation Procedures for Home Energy Rating Systems.

(C) Qualified individuals. Individuals qualified to determine compliance shall be only those individuals who are recognized by an organization certified by the Secretary for such purposes.

**(e) Basis reduction.**

For purposes of this subtitle, if a deduction is allowed under this section with respect to any energy efficient commercial building property, the basis of such property shall be reduced by the amount of the deduction so allowed.

**(f) Interim rules for lighting systems.**

Until such time as the Secretary issues final regulations under subsection (d)(1)(B) with respect to property which is part of a lighting system—

**(1) In general.**

The lighting system target under subsection (d)(1)(A)(ii) shall be a reduction in lighting power density of 25 percent (50 percent in the case of a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 (not including additional interior lighting power allowances) of Standard 90.1-2001.

**(2) Reduction in deduction if reduction less than 40 percent.**

(A) In general. If, with respect to the lighting system of any building other than a warehouse, the reduction in lighting power density of the lighting system is not at least 40 percent, only the applicable percentage of the amount of deduction otherwise allowable under this section with respect to such property shall be allowed.

(B) Applicable percentage. For purposes of subparagraph (A) , the applicable percentage is the number of percentage points (not greater than 100) equal to the sum of—

(i) 50, and

(ii) the amount which bears the same ratio to 50 as the excess of the reduction of lighting power density of the lighting system over 25 percentage points bears to 15.

(C) Exceptions. This subsection shall not apply to any system—

(i) the controls and circuiting of which do not comply fully with the mandatory and prescriptive requirements of Standard 90.1-2001 and which do not include provision for bilevel switching in all occupancies except hotel and motel guest rooms, store rooms, restrooms, and public lobbies, or

(ii) which does not meet the minimum requirements for calculated lighting levels as set forth in the Illuminating Engineering Society of North America Lighting Handbook, Performance and Application, Ninth Edition, 2000.

**(g) Regulations.**

The Secretary shall promulgate such regulations as necessary—

(1) to take into account new technologies regarding energy efficiency and renewable energy for purposes of determining energy efficiency and savings under this section , and

(2) to provide for a recapture of the deduction allowed under this section if the plan described in subsection (c)(1)(D) or (d)(1)(A) is not fully implemented.

**(h) Termination.**

This section shall not apply with respect to property placed in service after December 31, 2007.