

A Federal Level Analysis:

The Practical Use of Sec. 179D Green Building Deductions by A&E C-Corporations and C-Corps that Convert To Sub-S Status

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Mr. Don McDougall
National Sales Director
Engineered Tax Services, Inc.

Re: The Practical Use of Sec. 179D Green Building Deductions by A&E C-Corporations and C-Corps that Convert To Sub-S Status – A Federal Level Analysis

Dear Don:

You have shared with me that certain C-Corp architectural and engineering (A&E) firms that you have come in contact with could certainly qualify for the Sec. 179D(d)(4) deduction, but the A&E firms are not sure how the deduction can actually be utilized by them in their Federal level returns. As we all know, California does not have a similar tax deduction. Readers also need to remember that this is a federal level deduction – not a federal level tax credit.

While a basic working knowledge of Sec. 179D is presumed, a brief summary of the Sec. 179D process is attached as Exhibit A.

The bottom line is that C-Corp's can in fact take advantage of the Sec. 179D(d)(4) deduction in at least two big picture ways, as discussed herein.

- Remain a C-Corp and take advantage
- Convert to Sub-S status and take advantage

SEC. 179D AND CONTINUING C-CORPS

The Sec. 179D C-Corp Deduction. The Sec. 179D deduction itself enters the C-Corp tax return as a Sch. M-1 adjustment (a book and tax difference). The deduction is included with "other deductions" and is referred to in the other deductions schedule as "Sec. 179D Deduction."

The Sec. 179D deduction is an allowable as deduction against ordinary business taxable income for both regular tax purposes and alternative minimum tax purposes.

Amended federal C-Corp tax returns for all open years under the 3 year statute can be filed to claim the deduction.

The Basic C-Corp Road Block. Most A&E C-Corp's are cash basis taxpayers and the cash basis income is zeroed out during the year-end tax planning process. Sometimes, however, cash basis taxable income is unavoidable due to stock redemptions or repayments of debt. Most of the time, however, cash basis taxable income in C-Corps is nil to avoid the "double taxation" trap.

Okay, so the C-Corp is normal, meaning, it paid no C-Corp federal taxes for years 2006-2009 and prior years. It paid some California taxes in excess of the minimum of \$800 per year, however. Normally, the FYE tax plan focuses first on the federal taxes at its 35% rate and doesn't get too excited if there are some extra state taxes paid along the way at a 9% rate, rounded.

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Why file then 2006-2008 amended tax returns (maybe 2009 also if already filed) to claim the Sec. 179D deduction that should result in a net operating loss ("NOL"), which does not itself result in an immediate refund? Remember, you haven't paid any federal taxes at the C-Corp level, so carrying back the NOL to prior years won't result in an immediate refund either. You now have a NOL carryover that is good for 20 years, but can it be utilized?

Assuming the NOL limitation provisions of Sec. 382 do not apply (changes in ownership of more than 50% or loss of continuity, etc.), the NOL is technically available for use per Sec. 172.

The Sec. 179D NOL Carryover. Again, California does not have a Sec. 179D deduction, so we are talking about a federal level C-Corp NOL carryover only. Let's put some example numbers to this and personalize it for a C-Corp reader on how a Sec. 179D NOL carryover can work.

Assume that your 2006 C-Corp returns were extended and were filed on September 15, 2007. You, therefore, have until September 15, 2010, to amend this 2006 federal return. If the extended 2006 federal return was instead filed on August 15, 2007, then you have until August 15, 2010, to file the amended return.

Assume the energy savings studies for all of your projects placed in service for years 2006-2009 have been concluded and 100% of the deduction has been allocated to your firm. Let's also assume that the deduction each year was the same amount at \$1,000,000 per year - a total of \$4,000,000. The taxable income for these 4 years was originally \$0, so a NOL of \$4,000,000 has now been created. No taxes were paid in years prior to 2006, so the NOL is going to be carried forward.

Assume your firm will continue to qualify for a Sec. 179D deduction at the rate of \$1,000,000 per year for years 2010-2013.

Cash-basis taxable income and the utilization of the 2006-2009 NOL carryovers are expected to be as per below. Let's further assume, simplistically, that the cash-basis income each year was retained dollar for dollar in the bank account.

<u>Year Ending</u>	<u>Pre-Tax Income Before Current Sec. 179D & Before NOL</u>	<u>Less Current Year Sec 179D</u>	<u>Current Years Pre-Tax Income Before NOL</u>	<u>Less Use of 2006-2009 NOL</u>	<u>Remaining Pre-Tax Income</u>
2010	\$ 1,500,000	\$ (1,000,000)	\$ 500,000	\$ (500,000)	\$ 0
2011	1,500,000	(1,000,000)	500,000	(500,000)	0
2012	2,500,000	(1,000,000)	1,500,000	(1,500,000)	0
2013*	<u>2,500,000</u>	<u>(1,000,000)</u>	<u>1,500,000</u>	<u>(1,500,000)</u>	<u>0</u>
Totals	<u>\$ 8,000,000</u>	<u>\$ (4,000,000)</u>	<u>\$ 4,000,000</u>	<u>\$ (4,000,000)</u>	<u>\$ 0</u>

* The years included were cut-off at the end of 2013 reflecting the expected expiration of the deduction. There is some speculation, however, that the deduction will be extended to 2025.

As indicated, the current year Sec. 179D was fully utilized and all of the 2006-2009 NOL was also fully utilized. In conjunction with the current year Sec. 179D deduction benefit and the use of the NOL carryovers, \$8,000,000 of hard cash (except for the California taxes) did not have to be spent to reduce the federal level taxable income to zero. The California corporate tax effect (rounding down the state corporate rate from 8.84% to about 6% since the state taxes

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paid are a federal level deduction), would be about \$480,000 or so. The net hard cash build up after state taxes would be approximately \$7,520,000.

If there was no Sec. 179D deduction at all, would the C-Corp ever adopt a strategic plan of some sort that included paying federal and state corporate taxes on the \$8,000,000? It's possible, but probably not. The combined federal and state net tax cost of 41% rounded or \$3,280,000, with a remaining after tax amount of \$4,720,000, would normally be perceived as just too expensive.

The big-picture benefit of the Sec. 179D deduction in a continuing C-Corp environment can be summarized as follows:

<u>Scenarios</u>	<u>Hard Cash Build-Up At Corporate Level</u>
a. No Sec. 179D. Spend cash and zero out taxable income each year.	\$ <u>0</u>
b. No Sec. 179D. Accumulate cash on an after-tax basis.	\$ <u>4,720,000</u>
c. Maximum use of Sec. 179D, less California taxes paid.	\$ <u>7,540,000*</u>

* \$2,800,000 more than Scenario B

What To Do With The \$7,540,000? Whether your Scenario C amount is \$2M or \$7M, the important point to note is that your Company did not end up here by accident. Consistent with the goal of maximizing the Sec. 179D benefit, your Company would have had in place a C-Corp level game plan for the use of the hard cash build up. Some examples of uses could be as follows:

- * Retirement of bank or other debt.
- * Stock redemptions as part of the ownership transition plan.
- * Acquisition of another business.
- * Investment in new technology.
- * Relocation of the business.
- * Purchase of new equipment.

SEC. 179D AND THE SUB-S CONVERSION

Pros and Cons of the Sub-S Conversion. Existing C-Corps that meet the basic requirements of the election process can opt to convert to Sub-S status. Much has already been written over many years by many tax experts about the pros and cons of making the election. Now, however, the benefits of Sec. 179D need to be included in the pros and cons analyses. It will be presumed that the reader already has a basic understanding of said pros and cons and the election process.

"Built-In-Gains" Tax. An existing C-Corp that converts to Sub-S status will immediately become subject to the "built-in-gains" ("BIG") tax rules of Sec. 1374. California has the BIG tax also. A&E C-Corp's that convert to Sub-S status are subject to the federal and state BIG tax rules.

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The IRS asks the C-Corp taxpayer to value the Company at the date of conversion, assume December 31, 2009, at an amount as if the Company was being sold to an outside buyer, and calculate the net built-in-gain. For the normal A&E firm that utilizes the cash basis method of accounting for tax purposes, the net built-in-gain will mostly consist of the following two items:

- Accrual basis income items in excess of accrual basis deduction items (accounts receivables, work-in-process, prepaid expenses.....in excess of.....accounts payable, consultants payable, accrued payroll and other accrued expenses).
- Good will.

Sec. 1374 says that these net BIG items are tax attributes that originated while the Company was a C-Corp, and if they are disposed of within the next 10 years following the date of conversion, a C-Corp level BIG tax may result. That is correct. The Company is now a Sub-S and it could be responsible for paying a C-Corp level BIG tax if there is not very careful tax planning. It is this potential BIG tax that stops many C-Corp's dead in their tracks from making the Sub-S election. Who wants to wait 10 years before you can become a "real" Sub-S?

For most A&E firms, there will probably be no disposition or sale of the "goodwill" part over the next 10 years. It is almost guaranteed, however, that the accrual basis income items net of the accrual basis expense items will have been disposed of - most of which would have occurred in the Sub-S's first year of existence, which we will assume is 2010. This disposition process is quite normal and almost unavoidable. WIP is billed, receivables are collected, and payables and accrued expenses are paid, etc.

So, assume for the moment that the Company's net built-in-gain at December 31, 2009, consists of the following:

	<u>BIG</u>
* Accrual basis items in excess of accrual basis expenses	\$ 4,000,000
* Goodwill	<u>1,000,000</u>
Total Built-In Gain	<u>\$ 5,000,000</u>

Assume that the accrual basis items, net, were "disposed" of in the normal course of business as follows:

Disposed of in 2010 (realized but not recognized)	\$ 3,500,000
Disposed of in 2011 (realized but not recognized)	<u>500,000</u>
Total Dispositions	<u>\$ 4,000,000</u>

Realized versus recognized. Equate "realized" to a cocked gun. Equate "recognized" to a fired gun. While the above \$4,000,000 has been realized, it won't result in recognized taxable income if the modified net income of the Sub-S beginning in 2010 and for the following 9 years is tax planned down to zero. Exactly. Tax planned down to \$0 for 10 years, just as if the Company was still a C-Corp doing its normal FYE tax planning that includes a lot of Shareholder bonuses. Zeroing out the taxable income each year is one of the key Sec. 1374 escape hatches that prevent recognition. However, as long as the gun is still cocked, the Sub-S cannot entertain profit distributions without a very large tax cost.

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It will have had to tax plan that opportunity down to zero. At the end of 10 years though, the BIG tax is no longer an issue.

If the BIG tax planning goes awry, however, and the gun fired anytime during the 10 year period, there could be a combined federal and state, corporate and personal level tax rate of 65.2% and as much as \$2,608,000 in taxes on the \$4,000,000. This is a horror story. The calculation is as follows:

	<u>\$</u>	<u>%</u>
1. Accrual basis BIG items recognized - gun fired!	\$ 4,000,000	100.0%
2. Less F&S C-Corp BIG taxes @ 41%, net	<u>(1,640,000)</u>	<u>(41.0)%</u>
3. Subtotal - Balance taxable to shareholders	2,360,000	59.0%
4. Less F&S personal level ordinary taxes @ 41%	<u>(968,000)</u>	<u>(24.2)%</u>
5. Ending amount after BIG	<u>\$ 1,392,000</u>	<u>34.8%</u>
6. Total taxes (2 + 4)	<u>\$ 2,608,000</u>	<u>65.2%</u>

* The corporate and personal level effective tax rates are very close to being the same - each rounded to 41%.

The above is a worse-case scenario. As indicated, when the BIG tax is recognized, the total federal and state (corporate and personal level) tax rate could be as high as 65.2%. Less taxes will be paid, however, if all of the \$4,000,000 is not recognized during the 10 year period, in which case the Sub-S is still not operating as a full-fledged Sub-S, etc. Again, the mere thought of having to pay taxes at a 65.2% rate prevents many a C-Corp from converting to Sub-S status.

However, can the Sec. 179D deduction, or more specifically, can the Sec. 179D NOL carryover reduce or eliminate the federal level part of the BIG tax? The answer is emphatically yes and the Sub-S election is absolutely viable.

Sec. 179D NOL Carryover to Sub-S. In my example numbers on Page 2, I have a C-Corp NOL carryover of \$4,000,000 at the end of 2009. On Page 4, I purposely made the December 31, 2009, accrual basis items of the BIG equal to \$4,000,000. In the real world, these amounts won't be the same. In any event, my example gives me the perfect opportunity to use the C-Corp NOL carryover to completely offset the federal level BIG realized in 2010 and 2011. Remember, California does not have a Sec. 179D deduction, hence there can be no Sec. 179D NOL carryover at the state level to use to offset the state BIG.

Fire the Gun and Recognize the BIG. Knowing in advance that the Sub-S BIG can be reduced or eliminated in total with a purposely created Sec. 179D C-Corp NOL, gives us a green light to making the election to convert to Sub-S status and the opportunity to reap all of the benefits of a Sub-S sooner than later, if not right away. In other words, the comprehensive game plan will include the purposeful recognition of the BIG. This is accomplished by not zeroing out the Sub-S cash basis taxable income during the FYE tax planning process.....year-end Shareholder bonuses are reduced, etc.

Going back to the example numbers for years 2010-2013 on Page #2, assume that these same amounts are now for the Sub-S..... \$8M of pre-tax income before the current year Sec. 179D and \$4M of pre-tax income afterwards and before the 2006-2009 NOL carryover. If there was no \$4M NOL carryover and if the remaining \$4M of pre-tax income was not tax planned down to zero (shareholder bonuses, etc.), the \$4M of BIG would be recognized and the 65.2% total tax rate would be in play. The NOL carryover is there to be used, however, and \$8M in total of Sub-S federal income has been sheltered by the Sec. 179D deductions and NOL just like the \$8M was sheltered in the continuing C-Corp.

There is a California tax cost to this federal BIG strategy, however. All of the \$8M is taxable state income. None of it is sheltered by Sec. 179D. The first \$4M of state income would be the recognition of the BIG and the corporate and

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shareholder level taxes would be approximately 11.6% rounded, or \$464,000. The second \$4M of state taxable income would be subject to a California corporate Sub-S and shareholder level effective tax rate of approximately 7% rounded, or \$280,000. The total state tax cost would be approximately \$744,000, or about 9.3% of the \$8M starting point. All in all, an effective California tax rate of 9.3% to get through all of the BIG issues is not that high.

The Sub-S has now successfully eliminated the federal level BIG tax and paid the California level BIG tax and can now begin enjoying most if not all of the benefits of being a full fledged Sub-S. As a cautionary note, however, please remember that if the goodwill noted above is disposed of within the 10 year recognition period, a federal and state BIG tax may have to be recognized.

While the focus of this advisory letter has been the deduction benefits of Sec. 179D, it is important to note that the recognized federal or state BIG tax can also be offset by other C-Corp tax attributes with varying expirations, such as the following:

- General Business Tax Credits (which includes R&D tax credits) - Federal level only. California does not allow the usage of tax credits.
- Other NOL carryovers (meaning, not generated by Sec. 179D) - Federal and state level.
- Capital Loss Carryovers - Federal and state level.

REMINDER. This advisory letter was intended to cover only the related federal and California tax rules. Other states may allow the Sec. 179D deduction that would make the analyses even more favorable.

IN CONCLUSION, there is no question that the Sec. 179D deductions can be effectively used by a C-Corp, whether it wants to remain a C-Corp or consider converting to Sub-S status.

Please do not hesitate to contact me if there are any questions.

Sincerely,

Josiah G. Belden

JGB/nkv

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EXHIBIT A

THE SECTION 179D DEDUCTION SUMMARIZED

The IRS now allows architects and other designers to claim a tax deduction for certain energy savings systems installed in new or existing publicly-owned buildings. The deduction is available for commercial buildings placed in service in years 2006 - 2013 and the deduction could be as high as \$1.80 times the square footage of the building if the overall energy savings is at least 50%. Based upon the energy savings, a lesser rate per sq. ft. may apply.

This is a federal level deduction only. It is not a tax credit. California does not have a similar deduction.

This deduction opportunity for architects (and other designers) was first mentioned in the 2005 Energy Incentives Act....Code Section 179D(d)(4). "In lieu of the owner (the government entity) being entitled to the deduction, the person primarily responsible for designing the property shall be treated as the Taxpayer for purposes of the deduction." Since owners of public buildings don't need or use tax deductions, the allocation process prevents the otherwise available deduction from being lost.

Assume your "firm" was designated the primary designer and was allocated all of the deduction related to 500,000 sq. ft. placed in service in 2006 and that the maximum rate of \$1.80 per sq. ft. applied. A \$900,000 deduction results and the federal tax savings could be as high as 35% or \$315,000. Then you would look at the square footage placed in service in 2007, 2008, 2009 and then 2010-2013.

As part of the process, an energy savings study by an independent licensed engineer, such as Engineered Tax Services, Inc., has to be performed on the publicly-owned commercial building and the public owner of the building has to sign off on the allocation form that transfers the deduction to the designer(s).

The deduction itself enters the C-Corp tax return as a Sch M-1 adjustment (tax return deduction not included in books - a book and tax return difference, etc.). The deduction is included in "other deductions."

Amended federal C-Corp tax returns can be filed to claim the deduction for all open years under the 3 year statute.

The above is an abbreviated summary at best about Sec. 179D and if more information is needed, please contact us for our more detailed newsletter.