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Department of the Treasury

Washington, DC 20224

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Date:

March 14, 2002

Re: Application of the IRC section 179(b)(3) Limitation Rule to a Partnership and its Partners or an S Corporation and its Shareholders

Dear

This letter is in response to your letter, dated November 12, 2001, to the President of the United States, relating to the application of the taxable income limitation rule of section 179(b)(3) of the Internal Revenue Code to a passthrough entity, such as a partnership or an S corporation. In your letter you made reference to our earlier letter of August 20, 2001, in which we provided you with general information.

Section 179(a) of the Code allows a taxpayer to elect to deduct all or part of the cost of qualifying section 179 property in the year the taxpayer places the property in service. A taxpayer can do this instead of recovering the cost by taking depreciation deductions over a specified recovery period.

However, there are limitations under section 179(b) of the Code ("section 179(b) limitations") on the amount a taxpayer can deduct in a year. The total cost of section 179 property (i.e., the maximum dollar limit) a taxpayer can elect to deduct for 2002 is $24,000. See section 179(b)(1). If the cost of a taxpayer's qualifying section 179 property placed in service in a year is over $200,000, the maximum dollar limit is reduced for each dollar over $200,000 (but not below zero). See section 179(b)(2). The total cost a taxpayer can deduct each year is limited to the taxable income of the taxpayer derived from the active conduct by the taxpayer of any trade or business during such taxable year. See section 179(b)(3).

In the case of a partnership that elects to deduct the cost of qualifying section 179 property in the year the partnership places the property in service, section 179 of the Code provides **a special statutory rule** (section 179(d)(8)) requiring the section 179(b) limitations (including the taxable income limitation under section 179(b)(3)) to apply to the partnership and to each partner. Section 179(d)(8) also applies to an S corporation and its shareholders.

Section 1.179-2(c)(2) of the Income Tax Regulations specifically describes how to apply the taxable income limitation of section 179(b)(3) of the Code to a partnership and to each of its partners. Section 1.179-2(c)(2)(i) provides that the taxable income limitation applies to the partnership as well as to each partner. Section 1.179-2(c)(2)(i) specifically states that the partnership may not allocate to its partners as a section 179 expense deduction for any taxable year more than the partnership's taxable income limitation for that taxable year and that a partner may not deduct as section 179 expense deduction for any taxable year more than the partner's taxable income limitation for that taxable year. Section 1.179-2(c)(2)(iv) defines taxable income of a partnership. Section 1.179-2(c)(2)(v) defines a partner's share of partnership taxable income.

In your letter, you offer arguments for the position that a partnership or an S corporation is not a taxpayer for purposes of the section 179(b)(3) limitation and, as a result, you request that section 1.179-2(c)(2) of the regulations be corrected to reflect a "taxpayer" as not being a passthrough entity.

In Hayden v. Commissioner, 112 T.C. 115 (1999), aff'd, 204 F.3d 772 (7th Cir. 2000), the Tax Court and the U.S. Court of Appeals for the 7th Circuit addressed and rejected similar arguments that you are raising in your letter, which reflect your position that a partnership is not a taxpayer, for purposes of section 179(b)(3) of the Code. The Tax Court concluded that "[f]or purposes of section 179(b)(3)(A), a partnership is a taxpayer." 112 T.C. at 121. Further, the Tax Court concluded that it could not read the section 179(b)(3) limitation out of section 179(d)(8), as argued, because section 179(d)(8) specifically provides that, in the case of a partnership, the limitations of section 179(b) (which includes the section 179(b)(3) limitation) shall apply to a partnership and the partners. Accordingly, the Tax Court held that section 1.179-2(c)(2) of the regulations is consistent with section 179(b)(3) and section 179(d)(8) and their legislative histories, and is valid.

In affirming the Tax Court's decision in Hayden, the U.S. Court of Appeals for the 7th Circuit concluded that section 1.179-2(c)(2) of the regulations is consistent with the plain language of section 179(b)(3) and section 179(d)(8) of the Code. The Court stated that "especially in light of section 179(d)(8)'s explicit application of section 179 limitations to partnerships, the Treasury Department's reading of "taxpayer" to encompass partnerships in the section 179 context is reasonable." 204 F.3d at 775. Accordingly, the Court held that section 1.179-2(c)(2) is a reasonable and valid interpretation of section 179.

Further, like section 1.179-2(c)(2) of the regulations, section 1.179-2(c)(3) provides a similar rule for S corporations and S corporation shareholders. See Green v. Commissioner, T.C. Memo. 1998-356 (applying section 179(b)(3) of the Code to an S corporation).

Because the courts in Hayden have decided that section 1.179-2(c)(2) of the regulations is consistent with section 179(b)(3) and section 179(d)(8) of the Code and their legislative histories, and is valid, we do not believe that this regulation should be revised.

Thank you for writing. We hope this information will be helpful to you.

Sincerely,

Peter C. Friedman

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