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RECAPTURE OF INVESTMENT CREDIT— PARTNERSHIP AND SUBCHAPTER S CORPORATION TRANSACTIONS

I. INTRODUCTION

Investment credit recapture is a frequently overlooked area which is especially neglected in partnership and Subchapter S corporation transactions. The general recapture rule is that investment credit is recaptured upon the early disposition of property subject to the investment credit. The investment credit may also be recaptured upon the transfer of a partnership interest or the shares of a Subchapter S corporation even though no investment credit property is disposed of by the partnership or the Subchapter S corporation.¹ Thus, in negotiations involving the transfer of interests in partnerships or shares in Subchapter S corporations, the potential liability to the partners and shareholders for recapture should be considered, as advance planning can minimize the effect of recapture. This comment discusses the potential recapture problems that are involved in certain partnership and Subchapter S corporation transactions.

Part of the confusion surrounding investment credit is its on-off status. The investment credit was allowed by the 1962 Revenue Act, but was repealed by the 1969 Tax Reform Act. The Revenue Act of 1971 restored the credit. The current version is basically the same as that applied before the 1969 repeal.² Recently, there have been several proposals to increase the amount of the investment credit. If such proposals are adopted, the recapture of investment credit will become even more significant.

II. THE INVESTMENT CREDIT

The investment tax credit is a direct offset against tax liability. The amount of the credit is seven percent of the "qualified investment" in "section 38 property."³ The credit is limited to the first \$25,000 of the tax liability plus one-half of the excess of the tax liability over \$25,000.⁴ The basic provisions of the credit are found in sections 38 and 46 through 48.⁵

1. INT. REV. CODE OF 1954, § 47; Treas. Reg. §§ 1.47-1 - 1.47-6 (1967).

2. See INT. REV. CODE OF 1954, §§ 49, 50; Goode, *Restoration of the Investment Tax Credit and Accelerated Depreciation*, 21 TAX LAWYER 147 (1967).

3. INT. REV. CODE OF 1954, § 46(a)(1).

4. INT. REV. CODE OF 1954, § 46(a)(2). This limitation is \$12,500 for a married person who files separately, unless his spouse is not entitled to any credit. INT. REV. CODE OF 1954, § 46(a)(4).

5. INT. REV. CODE OF 1954, §§ 38, 46-48. Many articles have been written in depth about

The term "section 38 property" is defined by section 48 of the Internal Revenue Code. To be eligible for investment credit, property must be depreciable⁶ and have an estimated useful life of at least three years.⁷ All tangible personal property⁸ and certain tangible real property (excluding buildings) is eligible for investment credit.⁹

The credit is available for both new and used "section 38 property." Only the first \$50,000 of used property "cost"¹⁰ is eligible for the credit.¹¹ This limitation is \$25,000 for a married person who files separately, unless the other spouse has no qualified used property.¹² For partnerships and Subchapter S corporations, the \$50,000 limitation for used property is applicable at two levels. The partnership or Subchapter S corporation is limited to \$50,000 investment in used property. In addition the partners and shareholders are also limited to \$50,000 investment in used section 38 property.¹³ Thus in applying the limitation, the partners and shareholders must take

how the credit is calculated and what property is qualified. *See generally* Alkire, *The New, Reinstated Investment Credit: How Tax Men Should Plan For It*, 37 J. OF TAX. 338 (1972); Auerbach, *Investment Credit and Depreciation Before and After 1969 Reforms*, 4 IND. LEGAL FORUM 156 (1970); Holtz & Jenkins, *Restoration of Investment Credit and Accelerated Depreciation*, 45 TAXES 660 (1967). For general information on partnership transactions see Waldron, *Tax Traps in Partnership Transfers and Liquidating Distributions*, 23 U. MIAMI L.R. 211 (1968); WELLS, *Income Tax Consequences of Sales or Liquidations of Partnership Interests*, 60 LL. B.J. 702 (1972); Comment, *A Tax Guide for the General Practitioner: The Tax Consequences of Partnership Formation, Change in Membership, Dissolution, and Termination*, 41 MISS. L.J. 310 (1970).

6. INT. REV. CODE OF 1954, § 48. *See* Treas. Reg. § 1.48-1(b) (1974) for a discussion of what depreciation allowable means.

7. *See* Treas. Reg. 1.46-3(e) (1974) for the meaning of estimated useful life. *See also* Sturm, *Revenue Acts of 1971 Class Life System and Investment Tax Credit*, 30 N.Y.U. INSR. 1601 (1972).

8. *See* Treas. Reg. § 1.48-1(c) (1974) for a discussion of tangible personal property. *See also* S. REP. NO. 1881, 87th Cong., 2d Sess. (1962); *U.S. Code Cong. and Adm. News*, 87th Cong., 2d Sess., 3455-56 (1962).

9. *See* Treas. Reg. § 1.48-1(d) and (3) (1974) for the definition of other tangible property. *See also* S. REP. NO. 1881, 87th Cong., 2d Sess. (1962); *U.S. Code Cong. and Adm. News*, 87th Cong., 2d Sess., 3456-57 (1962).

10. INT. REV. CODE OF 1954, § 48(c)(3)(B) (emphasis added) which provides in part: (B) Cost- The cost of used section 38 property *does not include* so much of the basis of such property as is *determined by reference* to the adjusted basis of other property held at any time by the person acquiring such property [T]he cost of used section 38 property *shall not be reduced* with respect to the adjusted basis of any property disposed of if by reason of section 47, *such disposition involved an increase of tax* or a reduction of the unused credit carrybacks or carryovers described in section 46(b).

11. INT. REV. CODE OF 1954, § 48(c).

12. INT. REV. CODE OF 1954, § 48(c)(2)(B).

13. INT. REV. CODE OF 1954, §§ 48(c)(2)(D), 48(e).

into account both their individual investments in used section 38 property and the share that is attributed to them from the partnership or Subchapter S corporation.¹⁴

The amount of the "qualified investment" is determined by the useful life of the property. The useful life for investment credit purposes is the same as the useful life used in computing depreciation under section 167.¹⁵ The "qualified investment" is defined by section 46(c) as the aggregate of;

1. The applicable percentage of the basis of each *new section 38 property* . . . placed in service by the taxpayer during such taxable year, plus
2. The applicable percentage of the *cost* of each *used section 38 property* . . . placed in service by the taxpayer during such taxable year.¹⁶

The applicable percentage is controlled by the useful life and is shown in this table:

If the useful life is —	The applicable percentage is —
3 years or more but less than 5 years	33 1/3
5 years or more	66 2/3
7 years or more	100 ¹⁷

To illustrate with four new and used section 38 assets:

Property	Estimated useful life (in years)	Basis (or cost)	Applicable percentage	Qualified Investment
A (new)	4	\$60,000	33 1/3	\$20,000
B (new)	10	\$90,000	100	\$90,000
C (new)	6	\$150,000	66 2/3	\$100,000
D (used)	3	\$30,000	33 1/3	\$10,000
Total				\$220,000

14. This also applies to joint venturers who have elected pursuant to § 761 of INT. REV. CODE OF 1954 not to be treated as a partnership for purposes of subchapter K, Chapter 1, subtitle A of the Code. Olin Bryant, 46 T. C. 848 (1966), *aff'd*, 399 F.2d 800 (5th Cir. 1968); See Rev. Rul. 65-118, 1965-1 CUM. BULL. 30.

15. INT. REV. CODE OF 1954, § 167. Unlike depreciation, the amount of the investment credit allowed does not reduce the basis of the property.

16. INT. REV. CODE OF 1954, § 46(c)(1)(A) and (B) (emphasis added). For a discussion of "qualified investment" and "basis," see Treas. Reg. § 1.46-3(a) and (c) (1974). The cost of § 38 property equals the basis of such property less that portion of the basis which is determined by reference to the adjusted basis of other property Treas. Reg. § 1.48-3(b) (1974). For example, if property with an adjusted basis of \$1,500 is traded with \$500 cash for property with a fair market value of \$2000, the cost for § 38 purposes is \$500.

17. INT. REV. CODE OF 1954, § 46(c)(2).

18. Treas. Reg. § 1.46-3(b) (1974).

The credit is allowed only for the year in which the property was placed in service. However, unused credit may be carried back to each of the preceding three taxable years and, then, forward to each of the seven taxable years following the unused credit year. The current year's credits are taken first and, then, the earliest unused credits are taken.¹⁹

III. RECAPTURE OF INVESTMENT CREDIT UNDER SECTION 47

A. *The General Rule*

Section 47²⁰ is the basis for recapture of investment credit. Section 47 provides that there is a recapture of investment credit if property on which investment credit was taken, is disposed of or otherwise ceases to be section 38 property prior to the expiration of its estimated useful life.

The amount recaptured is determined by recalculating the amount of credit allowable. In recalculating the amount of the credit, the actual period of use is substituted for the estimated useful life in the formula for determining qualified investment. The amount of the recapture is the difference between the investment credit taken and the recomputed credit. The tax liability for the year in which investment credit property is prematurely disposed of is increased by the amount of the recapture.

Section 47 was designed to prevent taxpayers from abusing the investment credit. In the absence of section 47, a taxpayer could substantially reduce his tax liability by rapidly turning over investment credit property.²¹ Section 47 places the taxpayer in approximately the same position as he would have been had he claimed the actual life of the property in his initial computation of the credit. Recapture is not required unless the actual period of use results in a change in the applicable percentage.

19. INT. REV. CODE OF 1954, § 46(b)(1) and (2); Treas. Reg. § 1.46-2(a) (1974).

20. INT. REV. CODE OF 1954 § 47, which provides in part, Early disposition etc.—O if during any taxable year any property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the useful life which was taken into account in computing the credit under section 38, then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from substituting, in determining qualified investment, for such useful life the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceased to be section 38 property.

21. S. REP. No. 1881, 87th Cong., 2d Sess. (1962); *U.S. Code Cong. and Adm. News*, 87th Cong., 2d Sess., 3320 (1962).

Subject to the exceptions in section 47(b),²² recapture is triggered by transactions which are considered "dispositions" or "cessations" of section 38 property.

In general, property will be considered disposed of whenever it is sold, exchanged, transferred, distributed, involuntarily converted, or disposed of by gift: Thus, a cessation will occur when property is contributed to a partnership or to a corporation.²³

The Regulations²⁴ include in the term "disposition": a sale in a sale-and-leaseback transaction, a gift, and a transfer upon the foreclosure of a security interest. Several other transactions not covered in the Regulations are generally considered to be dispositions: a trade-in, corporate distributions in liquidation, contributions of property to certain partnerships or corporations, involuntary conversion, a reduction in the interest of a partner, Subchapter S shareholder or a beneficiary of an estate or trust, and a reduction in basis or cost of section 38 property.²⁵ The Regulations exclude from the term "disposition" a mere transfer of title to a creditor upon creation of a security interest.²⁶ A lease of section 38 property is also generally not considered a disposition²⁷ unless the lease is in substance a sale. Even if the transaction is a bona-fide lease, the lessor may elect to treat the lessee as a purchaser for the purpose of investment credit.²⁸

If the property does not continue to qualify as section 38 property in each subsequent year, recapture is triggered. Cessation com-

22. See note 32 and accompanying text *infra*.

23. S. REP. No. 1881, 87th Cong., 2d Sess. (1962); *U.S. Code Cong. and Adm. News*, 87th Cong., 2d Sess., 3450 (1962). In *Commissioner v. Brown*, 37 T.C. 461 (1961), 325 F.2d 313 (1963), *aff'd*, 380 U.S. 563 (1965), the court, faced with the problem of defining disposition, said "in the absence of anything contra in the legislative history, words in a taxing statute are to be given their ordinary meaning." 380 U.S. at 570, 571.

24. Treas. Reg. § 1.47-2(a)(1) (1974); Henry C. Mueller, 60 T.C. 36 (1973); Richard D. Lang, 72 P.H. Tax Ct. Mem. 15 (1972).

25. A disposition will include a reduction in basis under § 1017 which is made when a taxpayer excludes from gross income the gain arising from a discharge of indebtedness pursuant to § 108, if such reduction is made before the close of useful life of the property. To reduce the basis of the section 38 property with respect to the taxpayer triggers recapture. Treas. Reg. § 1.47-2(c) (1974); see Rev. Rul. 248, 1972-1 CUM. BULL. 16; Lyon and Schreiber, 191-3rd T.M., *Investment Credit — Qualification; Computation*.

A recent case in this area is *Frank R. Hammerstrom*, where a couple decided to make a pre-divorce property settlement agreement, and changed their business-related community property to property held as tenants-in-common. This change was held not to be a disposition. 60 T.C. 167 (1973), *acquiesced in*, 1973-2 CUM. BULL. 6.

26. Treas. Reg. § 1.47-2(a)(1) (1974).

27. Leased section 38 property must continue to qualify as section 38 property in the hands of the lessor, the lessee, or any sublessee. See Treas. Reg. § 1.47-2(b)(1) (1974).

28. See Treas. Reg. § 1.47-2(b)(1) and (2) (1974); see generally Skinner, *Lessor and Lessee Problems With the Investment Credit*, 24 N.Y.U. INST. 1585(1966).

monly occurs when the property is converted to a disqualifying use, such as from business to personal use.²⁹ Retirement or abandonment are also treated as cessations, since the property is no longer used in the taxpayer's trade or business and depreciation is no longer allowed.³⁰ The Regulations, however, provide that there is no cessation merely because no depreciation is taken in the subsequent year due to the depreciation method employed.³¹

B. *The Exceptions*

Section 47(b)³² provides three exceptions to the general recapture rule, whereby certain dispositions do not trigger investment credit recapture. The first exempts the transfer of investment credit property upon the death of the taxpayer. "Any section 38 property held by a taxpayer at the time of his death is deemed to have been held by him for its entire estimated life."³³ This exception includes a transfer to a surviving joint tenant upon the death of a co-tenant, the transfer of a partnership interest upon the death of a partner, or the transfer of stock in a Subchapter S corporation upon the death of a shareholder.

The second exception embraces transactions under section 368³⁴

29. Treas. Reg. § 1.47-2(e) (1974).

30. Treas. Reg. § 1.47-2(d) (1974).

31. Treas. Reg. § 1.47-2(a)(2)(ii) (1974); see also Lyon and Schrieber, 192-2nd T.M., *Investment Credit—Application; Suspension; Termination*.

32. INT. REV. CODE OF 1954, § 47(b) which provides in part:

Section Not To Apply in Certain Cases.—Subsection (a) shall not apply to—

(1) a transfer by reason of death, or

(2) a transaction to which section 381(a) applies. For purposes of subsection (a), property shall not be treated as ceasing to be section 38 property with respect to the taxpayer by reason of a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as section 38 property and the taxpayer retains a substantial interest in such trade or business.

33. Treas. Reg. § 1.47-3(b)(1) (1974); S. REP. NO. 1881, 87th Cong., 2d Sess. (1962); *U.S. Code Cong. and Adm. News*, 87th Cong., 2d Sess., 3453 (1962).

34. INT. REV. CODE OF 1954, § 381(a) which provides in part:

General Rule.—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334(b)(2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met), or (F) of section 368(a)(1), the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subparagraphs (B) and (C).

(reorganizations) and section 332 (liquidation of subsidiaries). Thus, a disposition of investment credit property, pursuant to a reorganization under section 368 or liquidation under section 332, does not trigger recapture provided the acquiring corporation succeeds to the tax attributes of the transferor corporation pursuant to section 381.³⁵ However, subsequent disposition of the property by the acquiring corporation prior to the expiration of the original estimated useful life will trigger recapture. Also, if within this period such property ceases to be section 38 property in the hands of the acquiring corporation, recapture is triggered. In the event recapture is triggered in the hands of the acquiring corporation, the actual useful life used to recompute the investment credit includes the period the property was held by the transferor corporation and the period held by the acquiring corporation.³⁶ Recapture will be triggered by a corporate liquidation under sections 333,³⁷ 334(b)(2),³⁸ or 337³⁹ and by any of the reorganizations pursuant to section 368 other than those listed above.

The third exception to the general recapture rule applies to a mere change in the form of conducting the taxpayer's trade or business. Several transactions may fall within the exception: (1) a sole proprietor transferring his trade or business to a partnership or corporation, (2) a partnership transferring a trade or business to a corporation, and (3) a corporation transferring a trade or business to a partnership. The exception appears broad on its face, but the Regulations impose four conditions which limit its scope:

For an extensive discussion of investment credit problems in corporate liquidations and reorganizations, see generally Hertz, *Liquidation of a Corporate Business in Kind: Form of Continued Operations; Recapture; Installment; Winding Up; Reincorporation*, 26 N.Y.U. INST. 969 (1968); Walsh, *Effect of the Investment Credit and Depreciation Recapture on Basis in Corporate Liquidations*, 24 N.Y.U. INST. 1569 (1966).

35. The § 381(a) exception applies to five transactions: (1) a section 332 complete liquidation of a subsidiary, except where pursuant to section 334(b)(2) the transferee corporation's basis in the property is the same as its basis in the stock of the subsidiary corporation; (2) a statutory merger or consolidation under section 368(a)(1)(A); (3) an exchange of substantially all the property of one corporation solely for the voting stock of another corporation or of its parent corporation under section 368(a)(1)(C); (4) a transfer of all or part of the assets of one corporation to a controlled corporation followed by the complete liquidation of the transferring corporation under section 368(a)(1)(D); and (5) a reorganization involving a mere change in identity, form, or place of incorporation under section 368(a)(1)(F).

36. The acquiring corporation also stands in the shoes of the transferor corporation with respect to carryover of unused credits.

37. INT. REV. CODE OF 1954, § 333.

38. INT. REV. CODE OF 1954, § 334.

39. INT. REV. CODE OF 1954, § 337.

- (a) The section 38 property . . . [must be] retained as section 38 property in the same trade or business,
- (b) The transferor (or in the case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) of such section 38 property [must] retain a substantial interest in such trade or business,
- (c) Substantially all the assets (whether or not section 38 property) necessary to operate such trade or business [must be] transferred to the transferee to whom such section 38 property is transferred, and,
- (d) [T]he basis of such section 38 property in the hands of the transferee [must be] determined in whole or in part by reference to the basis of such section 38 property in the hands of the transferor.⁴⁰

These requirements must be met throughout the original estimated useful life of the property, and not just at the time of the change-in-form. If any condition is not met, the property ceases to be section 38 property and the transferor must recapture investment credit.

The first condition is that the property be "retained" in the same trade or business throughout the original estimated useful life of the property. The phrase "same trade or business" is not defined in the Regulations, but a mere addition of a new line of business to an existing line or the discontinuance of one line while continuing to handle others would probably be considered within the same trade or business.⁴¹

The second requirement is that the transferor retain a substantial interest in the trade or business, throughout the original estimated useful life of the investment credit property. The Regulations define a "substantial interest" as an interest which (1) "is substantial in relation to the total interest of all persons", or (2) "is equal to or greater than his interest prior to the change in form."⁴² The test for a substantial interest is not based on the relationship between the *value* of the interest retained and the *value* of the interest surrendered. Rather, the test is based on the *percentage of ownership* retained by the taxpayer in the new form of business as

40. Treas. Reg. § 1.47-3(f)(ii) (1974).

41. See Borini, *Investment Credit Recapture Problems Not Answered by the Regulations*, 24 N.Y.U. INST. 1535, 1544, 1545 (1966), where the author reaches the same conclusion applying § 382 of the INT. REV. CODE OF 1954. See also Wallace Corp., 64 P-H Tax Ct. Mem. 43, 53 (1964); Euclid - Tenn., Inc., 41 T.C. 752, 758 (1964).

42. Treas. Reg. § 1.47-3(f)(2) (1974). If a taxpayer owns a five percent interest in a partnership before incorporation, he must retain at least five percent interest in the corporation to qualify under this section.

compared with the *percentage of ownership* held by the taxpayer in the previous form of business. Where a sole proprietorship incorporates, a forty-five percent interest in the corporation received by the owner of the sole proprietorship will be considered a substantial interest.⁴³ Where a multi-business corporation transfers all the assets of one business to a partnership and receives a fifty percent interest in the partnership, this too will qualify as a substantial interest retained.⁴⁴ Where the transferring entity is a partnership or a Subchapter S corporation, only those partners or shareholders who retain a substantial interest are protected from recapture. Thus, where a partnership incorporates and one partner receives cash and no interest in the corporation, recapture is triggered as to that partner.⁴⁵ The requirement of a substantial interest must be met throughout the original estimated useful life of the property. Thus, each time the transferor disposes of a part of his interest in the new form of business, he is exempted only if the interest he retains is substantial.⁴⁶

This second condition was challenged in *James Soares*.⁴⁷ The taxpayer, a sole proprietor, acquired section 38 property and claimed investment credit in the years 1962 and 1963. On January 1, 1964, he formed a partnership with an existing Subchapter S corporation and contributed all the assets of his sole proprietorship to the new partnership. The taxpayer took a forty-eight percent interest in the partnership and the Subchapter S corporation took the remaining fifty-two percent. On July 1, 1964, the taxpayer exchanged his partnership interest for a 7.22 percent interest in the Subchapter S corporation and the partnership was dissolved. The taxpayer claimed he retained a substantial interest under section 47(b) since the book value of his partnership interest was equal to the fair market value of the Subchapter S stock. The Tax Court held that the taxpayer did not retain a substantial interest after the change-in-form and hence recapture was required. The court relied on section 1.47-3(f)(2)(i) stating that the Regulations make it clear that it is the percentage interest rather than the value of the interest in the business that must remain unchanged.⁴⁸

43. Treas. Reg. § 1.47-3(f)(6) Example 1 (1974).

44. Treas. Reg. § 1.47-3(f)(6) Example 5 (1974).

45. Treas. Reg. § 1.47-3(f)(6) Example 3 and 4 (1974).

46. S. REP. No. 1881, 87th Cong., 2d Sess. (1962); *U.S. Code Cong. and Adm. News*, 87th Cong., 2d Sess., 3453 (1962).

47. 50 T.C. 909 (1968).

48. *James Soares*, 50 T.C. at 913 (1968). For criticism of the holding in *Soares* see De Leoelos, *Consequences of Changing Forms of Doing Business*, 46 TAXES 865 (1968).

*Purvis v. U.S.*⁴⁹ also involved the second requirement. The taxpayer held 50 percent of the stock in a corporation. Upon the sale of the stock to another corporation, the taxpayer received only a percentage interest in the net profits. The taxpayer claimed he had retained a substantial interest even though he retained no stock ownership or control in the acquiring corporation. The Court found the taxpayer had not met the substantial interest test, since the retention of ownership must be represented by a continuing stock interest. The most recent case in this area is *Henry C. Mueller*.⁵⁰ The taxpayer attempted to bring a transfer of property to his bankruptcy trustee within the change-in-form exception. The Tax Court required recapture because the taxpayer failed to meet the substantial interest requirement.

A corporate liquidation does not meet the change-in-form exception, because the substantial interest test is not met. After liquidating, the corporation ceases to exist and retains no interest in the new business entity. Corporate spin-offs and split-ups likewise do not meet the change-in-form exception. After the spin-off or split-up, the transferor corporation retains no interest in the newly created corporation.⁵¹

The third condition requires that substantially all the assets necessary to operate the trade or business be transferred to the new business entity. All property used in the trade or business, whether section 38 property or not, is considered necessary. In addition, liquid assets which may be needed to meet unexpected expenses are considered assets necessary to the trade or business. If the transferor has more than one trade or business, only the assets of one trade or business need be transferred. However, a partial or complete liquidation involving an equal division of one trade or business among the shareholders, who continue to operate the same trade or busi-

49. 31 Am. Fed. Tax R.2d 73-428 (D.C. Ga. 1972).

50. 60 T.C. 36 (1973), 496 F.2d 899 (5th Cir. 1974).

51. These transactions can generally be divided into three categories, two of which trigger recapture: 1. Corporate Split-off - where a multi-business corporation transfers one business and substantially all of the assets of this one business to a new corporation. The transferor corporation retains the stock of the new wholly owned subsidiary and there is no recapture. 2. Corporate Spin-off - this is the same as a corporate split-off but there is a distribution of the subsidiary's stock to the shareholders of the transferor corporation. There is recapture here since the transferor corporation does not retain any interest in the trade or business. 3. Corporate Split-up - where a corporation is split-up into two or more separate corporations. The shareholders of the old corporation receive the stock of the new corporation and surrender their old stock. The old corporation is then dissolved. This triggers recapture since the transferor corporation ceases to exist. See Rev. Rul. 74-101, 1974-1 CUM. BULL. 7; Rev. Rul. 391, 1970-2 CUM. BULL. 3.

ness, will fail to meet this third requirement, because none of the shareholders receive substantially all of the assets of the trade or business. More important is the requirement that *assets must be transferred*. The Senate report states this as follows: "The phrase 'a mere change in the form of conducting the trade or business' . . . applies *only* to cases *where the properties of a trade or business are transferred*".⁵² This excludes from the exception mere changes in the form of holding property and changes in the form of reporting income.

The fourth requirement is that there be a carry-over basis from transferor to transferee. This eliminates taxable corporate liquidations from the exceptions, because there is no carry-over basis.⁵³

IV. RECAPTURE OF INVESTMENT CREDIT ON PARTNERSHIP TRANSACTIONS

A. *The Partner's Share*

Each partner is allocated his share of the basis of the partnership's new section 38 property and his share of the cost of used section 38 property. The partner is treated as the taxpayer with respect to this share.⁵⁴ The amount of the partner's share of the basis or cost to be allocated is determined according to the ratio in which the partners divide the general profits of the partnership, unless the partnership agreement provides for a special allocation for section 38 property.⁵⁵ However, the Regulations⁵⁶ include a provision whereby a 5 percent or smaller partner who is planning to retire within seven years after the current taxable year may elect not to take into account his share of the basis of partnership section 38 property. Such a retiring partner may in this manner avoid recapture on retirement. Any basis not taken into account by such a retiring partner is allocated to the other partners according to their interests in the general profits.

The partners must account for their share of the partnership's qualified investment in their respective taxable year within which

52. S. REP. NO. 1881, 87th Cong., 2d Sess. (1962); *U.S. Code Cong. and Adm. News* 87th Cong., 2d Sess., 3320 (1962).

53. Rev. Rul. 73-515, 1973-2 CUM. BULL. 7.

54. Treas. Reg. § 1.46-3(f)(1) and (2) (1974).

55. Treas. Reg. § 1.46-3(f)(2)(ii) (1974).

56. Treas. Reg. § 1.46-3(f)(2)(iii) (1974). The provisions has three requirements: (1) the retiring partner has an interest in the general profits of 5 percent or less, (2) according to the partnership agreement he will retire during the taxable year or within 7 years after the end of such year and (3) the partnership agreement provides that such a partner described in (1) and (2) does not have to take his share into account.

the partnership taxable year ends. This share is based on the amount of section 38 property placed in service by the partnership during the partnership's taxable year. The share is allocated even though the partnership shows a loss for that year. The partner's estimated useful life is the same as the estimated useful life in the hands of the partnership.

B. *Disposition or Cessation in the Hands of the Partnership*

If a partnership disposes of investment credit property prematurely or such property ceases to be section 38 property in its hands, then each partner will be required to recapture investment credit. Each partner's liability is based on his share of the qualified investment taken when the property was placed in service. The actual life used to recompute the credit begins on the date the property was placed in service by the partnership and ends with the date of the disposition or cessation.⁵⁷

C. *Disposition of a Partner's Interest*

1. The 66 2/3% — 33 1/3% Rule

If a partner transfers his entire interest in the partnership prior to the expiration of the estimated useful life of any partnership property on which the partner has taken investment credit, recapture is triggered. In recomputing the investment credit, the period of time the partner had an interest in the property is used as the actual useful life. However, to avoid the complexity of recapture when the taxpayer sells only a non-substantial portion of his interest in the partnership, the 66 2/3%—33 1/3% rule controls recapture on the sale of a portion of a taxpayer's partnership interest. Under this rule, recapture is triggered when a partner's proportionate interest in the partnership falls below 66 2/3 percent of what his interest in the partnership was in the year in which the investment credit was taken. In other words, recapture may be avoided if a partner does not reduce his interest in the partnership by more than one-third of his original interest when the property was placed in service. Once there has been a recapture because of a reduction below 66 2/3 percent, there will be no further recapture until the partner's interest is reduced below 33 1/3 percent of what it was when the property

57. Treas. Reg. § 1.47-6(a)(1) (1974). To illustrate: A and B are partners who share profits equally. The partnership had \$60,000 in qualified investment with ten year useful life which gives both partners \$2,100 credit. If the partnership immediately sells \$30,000 of the property, both A and B have a recomputed credit of \$1,050 and an increase in tax in the year of disposition of \$1,050.

was placed in service.⁵⁸ The Regulations have no provision for recapture on subsequent reductions of interest below 33 1/3 percent. There are two possibilities. The first is that any reduction below 33 1/3 percent no matter how slight will trigger recapture. However, this view is not consistent with the remainder of the rule. The better-reasoned view is that there is no further recapture until the partner completely disposes of his interest. The Internal Revenue Service has not adopted a published position on this problem.

When recapture is triggered pursuant to the 66 2/3%—33 1/3% rule, the amount of property that is considered to have ceased to be section 38 property is the same proportionately as the actual reduction in partnership interest. The amount of property that is considered to have ceased to be section 38 property includes prior reductions that did not reduce the partner's interest below 66 2/3% as well as the reduction that brought it below 66 2/3%. Assume for example, a partner who owns 60 percent of the partnership has \$100 of the basis of section 38 property allocated to him. When his interest in the partnership is reduced to 30 percent (50 percent reduction), the partner has \$50 of investment credit property subject to recapture. If this 30 percent interest is reduced further to 15 percent (25 percent of the original interest), then another \$25 would cease to be section 38 property.

In applying the 66 2/3%—33 1/3% rule, a partner's interest in the partnership is deemed to include any interest in the partnership that he owns indirectly through ownership of other entities. However, constructive ownership applies only where the basis of the partnership interest to the other entity is determined in whole or in part by reference to the basis such interest originally had in the hands of the partner, *i.e.*, where there is a carryover basis in the partnership basis from the attributee to the attributor.⁵⁹ For example, when a partner who owns one-third of the partnership transfers his partnership interest to a corporation in exchange for all the corporation's stock, he is still considered to be the indirect owner of one-third interest in the partnership. Therefore through indirect ownership, his interest has not been reduced and no recapture is

58. Treas. Reg. § 1.47-6(a)(2)(i) and (ii). For illustration: A and B are partners and each have fifty percent profit interest. The partnership has qualified investment in \$60,000 of newly acquired section 38 property with a ten year life. A and B each get \$2,100 of investment credit. A immediately sells one-half of his interest, which triggers recapture and the investment credit is decreased by \$1,050 (seven percent of \$15,000) and A's tax for the year is increased by \$1,050. A year later A sold his remaining twenty-five percent, thus reducing his interest below 33 1/3 percent and the tax for the year of the sale would be increased by \$1,050.

59. Treas. Reg. § 1.47-6(a)(2)(iii) (1974).

required. If thereafter, the partner disposes of some of his interest in the partnership, the 66 2/3% rule is applied to the total of his actual interest and his indirect interest. Further, any disposition by the partner of his interest in the corporation or other entity which holds his indirect interest will constitute a disposition of a portion of his interest in the partnership, which will likewise be tested by the 66 2/3% rule.

2. No Credit Allowed When Partnership Interest Acquired

The purchaser of a partnership interest is not entitled to investment credit for the purchase of used section 38 property. This seems inconsistent with the rule that a seller of a partnership interest must recapture investment credit. It can be argued that the buyer should be allowed used investment credit on the purchase of the partnership interest. This argument is countered in two ways. First, an interest in a partnership is not within the definition of section 38 property. However this rationale is not consistent because the sale of a partnership interest is considered to be a disposition of the section 38 property held by the partnership. The purchase of a partnership interest should be considered to be the acquisition of the section 38 property held by the partnership. Second, the purchaser of a partnership interest is not allowed investment credit for the purchase of used section 38 property on the basis of section 48(c)⁶⁰ and the Regulations⁶¹ promulgated thereunder. Section 48(c) contains two possible grounds for the denial of the credit. First, it prohibits investment credit for the purchase of used section 38 property if such property is used after acquisition by one who used it before such acquisition. In the case of a partnership, the partnership property is considered under the regulations to be used by all partners. The Regulations⁶² interpret section 48(c) to prohibit investment credit on the purchase of a partnership interest on the theory that the section 38 property is used both before and after the purchase by the non-selling partners and is therefore used after the acquisition by one who use it before the acquisition. It could be argued that the Regulations apply to section 48(c) improperly by providing that property used by a partnership is considered to be

60. INT. REV. CODE OF 1954 § 48(c)(1) which provides in part:

Property shall not be treated as "used section 38 property" if, after its acquisition by the taxpayer, it is used by a person who used such property before such acquisition (or by a person who bears a relationship described in § 179(d)(2) A (or B) to a person who used such property before such acquisition).

61. Treas. Reg. § 1.48-3(a)(2)(i) (1974).

62. Treas. Reg. § 1.48-3(a)(2)(ii) (1974).

used by each partner. The purchasing partner is not attempting to get investment credit for all the section 38 property held by the partnership, rather he is seeking to get used investment credit for only the selling partner's share of section 38 property. In *Edward A. Moradian*,⁶³ the Tax Court rejected the Treasury's view that partnership property is used by each partner individually. Thus it would seem that in so far as this limitation in section 48(c) is concerned, a purchaser of a partnership interest should be able to receive used investment credit. However, Section 48(c)(1) also prohibits investment credit for used section 38 property if such property is used after acquisition by one who bears a particular relationship to the person who used the property before the acquisition.⁶⁴ One of the proscribed relationships exists between two partnerships with a greater than 50 percent common ownership.⁶⁵ Thus the purchaser of a partnership interest cannot get investment credit for used section 38 property if there is greater than 50 percent common ownership in the partnership before and after the acquisition.

D. *Liquidation of a Partnership*

It is clear that the liquidation of a partnership and distribution of the qualified property to the partners triggers recapture of investment credit. The property has ceased to be section 38 property because the property is no longer in service in the hands of the partnership.

The liquidation of a partnership cannot fit within the change-in-form exception, even though the form partners as individuals use the same assets in the same trade or business. The third and fourth conditions of the change-in-form exception are not met: (1) substantially all the assets, as a whole, could not be distributed to every partner, and (2) there is no carry-over basis in a complete liquidation and distribution. The Regulations provide that partners who acquire partnership property in a liquidation and continue to use it in trade or business are not allowed investment credit for used section 38 property. Since property held by a partnership is deemed to be used by all the partners individually, the partner who acquires section 38 property in liquidation is considered to have used such property before such acquisition.⁶⁶ However, this Regulation is ques-

63. 53 T.C. 207 (1969), *non acquiescence in*, Rev. Rul., 1973-2 CUM. BULL. 4, Rev. Rul. 74-64, 1974-1 CUM. BULL. 12.

64. INT. REV. CODE OF 1954, § 179(d)(2)(A).

65. INT. REV. CODE OF 1954, § 707(b).

66. Treas. Reg. § 1.48-3(a)(2) (1974).

tionable after the decision in *Edward A. Moradian*,⁶⁷ where the Tax Court held that a partnership should be treated as an entity distinct from its partners and rejected the Treasury's view that a partnership's use of the property is attributed to each partner individually. Nevertheless, the limitation of section 179(d)(2)(A) is applicable here, so that if a partner owned greater than 50 percent of the partnership, he may not take investment credit for the used section 38 property received in liquidation.⁶⁸

E. *Incorporation of a Partnership*

A partnership may be incorporated without recapturing investment credit by meeting the requirements of the change-in-form exception. The requirements of the exception may be complied with fairly easily. The second requirement may cause some problems, however, since the partners as transferors must retain a substantial interest in the trade or business for the entire original estimated useful life of the section 38 property. Whenever a partner fails to retain a substantial interest throughout the original estimated useful life of the property, recapture is triggered.⁶⁹

This requirement was challenged in *Mitchell A. Aboussie*.⁷⁰ There, a three-man partnership was incorporated. The taxpayer sold his one-third stock interest to another stockholder six months after incorporation. The Tax Court held that the taxpayer did not retain a substantial interest in the corporation after the sale and recapture was triggered. The taxpayer contended that section 1.47-3(f)(5) of the Regulations was unreasonable, arbitrary, and therefore invalid, since it required the shareholder rather than the corporation to recapture investment credit. The Tax Court upheld the validity of these Regulations stating that the taxpayer is liable for recapture, since it was the sale of the taxpayer's stock that triggered the recapture. The taxpayer also argued that the "so long as" clause of section 47(b)⁷¹ applied only to the requirement that the transferee retain the section 38 property. The taxpayer contended that Section 47(b) does not require that the transferor retain a substantial inter-

67. *Supra* note 63.

68. INT. REV. CODE OF 1954, § 702(b).

69. Treas. Reg. § 1.47-3(f)(5)(ii) (1974).

70. 60 T.C. 549 (1973). The taxpayer challenged the Regulations' interpretation of § 47(b) found in Treas. Reg. § 1.47-3(f)(1) and (5) (1974).

71. INT. REV. CODE OF 1954, § 47(b) which provides in part:

[P]roperty shall not be treated as ceasing to be section 38 property with respect to the taxpayer by reason of a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as section 38 property and the taxpayer retains a substantial interest in such trade or business.

est in the trade or business. If interpreted in this way, the transferor would only have to retain a substantial interest at the time of the change-in-form. The court found the taxpayer's interpretation to be contrary to the congressional intent⁷² of section 47(b).

When incorporating a partnership, the sequence of the transactions is crucial. To avoid recapture, the partnership should first incorporate and then distribute the stock to the partners in a liquidation of the partnership. If the partnership property is first liquidated to the partners and the partners as individuals then transfer the assets to the corporation, recapture is likely to be triggered on the first half of the transaction; the liquidation of the partnership.

The avoidance of investment credit recapture in the incorporation of a partnership may result in the loss of the benefits of section 1244.⁷³ The benefits of section 1244 flow only to the original shareholders of the corporation. Thus, if the partnership liquidates and the partners incorporate, the benefits of section 1244 are available to the partner-shareholders. However, as discussed above recapture of investment credit is triggered in this sequence of transactions. If on the other hand, the partnership incorporates and the stock is liquidated to the partners, the partnership is the original shareholder, and upon the liquidation of the stock to the partners, the benefits of § 1244 are lost.⁷⁴ Recapture is not triggered in this later sequence of transactions. Therefore, the considerations of recapture of investment credit and the benefits of § 1244 must be balanced in order to determine in what sequence to cast the transaction.

Where a partnership incorporates into a new corporation and the partners retain a substantial interest without changing the percentage ownership, the change-in-form requirements can be met. However, where the transfer is made to a corporation with existing shareholders, it is difficult for the partners to retain a percentage of ownership equal to or greater than the percentage of ownership in the partnership.

F. *Reduction in Interest after a Change in Form — Which Continuity of Interest Test Controls?*

Two continuity of interest tests have been discussed. The first is the "substantial interest" test found in the change-in-form exception of section 47(b): "[P]roperty shall not be treated as ceasing to be section 38 property . . . so long as . . . the taxpayer retains a

72. S. REP. NO. 1881, 87th Cong., 2d Sess. (1962); *U.S. Code Cong. and Adm. News*, 87th Cong., 2d Sess., 3433 (1962).

73. INT. REV. CODE OF 1954, § 1244.

74. Treas. Reg. § 1.1244(a)-1(c) Example (2) (1974).

substantial interest in such trade or business." In other words, after a change-in-form, property will *cease* to be qualified property unless the taxpayer retains such interest. The interest required is further defined as: (1) "substantial in relation to the total interest" or (2) "equal or greater than his interest held prior to the change".⁷⁵ The second test, the 66 2/3%-33 1/3% rule, is found in the Regulations under *disposition* of a partner's interest.⁷⁶ This rule provides that a reduction in a partner's interest below the percentages prescribed is a disposition which triggers recapture.

The tests conflict where the taxpayer initially retains a substantial interest after a change-in-form, but subsequently reduces his interest prior to the expiration of the original estimated useful life of the property, below 66 2/3 percent of the interest he had when the section 38 property was placed in service. This situation would seem to trigger recapture under the partnership Regulations. However, the transaction would also seem to come within the section 47(b) change-in-form exception, and recapture would not be triggered if the interest retained is substantial, even though less than 66 2/3%. The Regulations under section 1.47-3(f)(5)(iv) provide that should this occur, the 66 2/3%-33 1/3% partnership test is to be applied.

This Regulation⁷⁷ was challenged in *W. Frank Blevins*.⁷⁸ The taxpayer, as a partner, took investment credit in 1965 and 1966. At the end of 1966, the partnership was incorporated and the taxpayer retained the same forty-five percent interest in the corporation as he had owned in the partnership. In 1968, the taxpayer made gifts of stock in the corporation. The gifts reduced the taxpayer's interest by over fifty percent leaving him with a twenty-one percent interest in the corporation. The question was whether this reduction in interest triggered recapture. The court held that recapture was triggered. The court found that the incorporation of the partnership was within the section 47(b) change-in-form exception. The Court then found that the partnership Regulations,⁷⁹ which provide for the 66 2/3% - 33 1/3% rule, were applicable by reason of section 1.47-3(f)(5)(iv) of the Regulations.⁸⁰ Further, the court found that under

75. Treas. Reg. § 1.47-3(f)(2)(i) and (ii) (1974).

76. Treas. Reg. § 1.47-6(a)(2)(i) and (ii) (1974).

77. Treas. Reg. § 1.47-3(f)(5)(iv) (1974).

78. 61 T.C. No. 59 (Jan. 26, 1974).

79. Treas. Reg. § 1.47-6(a)(2) (1974).

80. The court first analyzed the facts under the section 47(b) change-in-form exception. After the gifts were made, the taxpayers retained only a 21 percent interest. Both the taxpayer and the Treasury seemed to have assumed that a 21 percent interest would be a substantial interest for the purposes of § 47(b). The Tax Court expressly reserved opinion on this issue. 61 T.C. at 339.

Aboussie,⁸¹ discussed previously, the 66 2/3% - 33 1/3% rule would apply not only at the time of the change-in-form but until the end of the estimated useful life of the section 38 property. A close look at the language used explains why the Court upheld the Regulations. The change-in-form exception, which the taxpayer had complied with,⁸² only provides that the property shall not be treated as *ceasing* to be section 38 property. A reduction in interest is itself a triggering event. Thus even though the change-in-form exception is met and a cessation does not occur, this does not exempt other triggering events from causing recapture. This case would probably not have been decided on this section of the Regulations if the parties had focused on the issue of whether a 21 percent interest reduced from 45 percent was a substantial continuing interest. However, *Blevins* serves as a reminder that coming within the change-in-form exception does not end a partner's recapture problems. Another independent occurrence may cause recapture.

V. RECAPTURE OF INVESTMENT CREDIT AND THE SUBCHAPTER S CORPORATION

A. *The Subchapter S Election*

Much of what has been written under the partnership section applies to Subchapter S transactions, since both entities have similar tax characteristics.⁸³ The emphasis of this section will be on the transactions peculiar to Subchapter S corporations and their recapture potential. Pursuant to section 48(e),⁸⁴ the qualified investment of a Subchapter S corporation is allocated pro-rata among the shareholders, as of the last day of the corporation's taxable year. Each shareholder is treated as the taxpayer with respect to his respective share of such investment. Each shareholder in determining his total investment credit includes both his personal investment in

81. See note 70 and accompanying text *supra*.

82. Assuming as the Court does that twenty-one percent is a substantial interest retained. See note 79 *supra*.

83. INT. REV. CODE OF 1954, § 1372.

84. INT. REV. CODE OF 1954, § 48(e) which provides in part:

(e) Subchapter S corporations - In the case of an electing small business corporation . . . -

(1) the qualified investment for each taxable year shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such taxable year; and

(2) any person to whom any investment has been apportioned under paragraph (1) shall be treated . . . as the taxpayer with respect to such investment

section 38 property and his share of the corporation's qualified investment in section 38 property.

The election to be taxed under Subchapter S, pursuant to section 1372, may result in investment credit recapture.⁸⁵ Any section 38 property on which the corporation has taken investment credit ceases to be section 38 property on the last day of the taxable year immediately preceding the first year in which the Subchapter S election is effective. However, the corporation may avoid this recapture if it executes an agreement in accordance with section 1.47-4(b)(2) of the Regulations.⁸⁶ The agreement, signed by the shareholders and the corporations, provides that in the event any pre-election property is prematurely disposed of or otherwise ceases to be section 38 property during a taxable year in which the Subchapter S election is in effect, the parties agree to: (1) notify the district director of any subsequent disposition or cessation, and (2) to be jointly and severally liable for any increase in tax due to recapture. To avoid recapture, the agreement must be filed on or before the due date for the corporation's pre-election year return.⁸⁷ The agreement to treat the property as ceasing to be section 38 property in the taxable year preceding the Subchapter S election is needed to hold the shareholders and the corporation liable for the recapture tax, since section 1372(b)(1) relieves a Subchapter S corporation from liability for all income tax including recapture of investment credit.⁸⁸

A problem arises where the disposition or cessation occurs in a year in which the Subchapter S election is no longer in effect and thus, the agreement by the corporation and shareholders to be liable for the recapture is also no longer in effect.⁸⁹ The Regulations do not provide for the situation where the property on which the recapture is required was purchased prior to the subchapter S election. However, the corporation, having received the credit, should consequently be liable for the recapture. If, on the other hand, the property on which the recapture is required was purchased when the Subchapter S election was effective, the Regulations⁹⁰ provide that the shareholders are liable for recapture.

85. Treas. Reg. § 1.47-4(b)(2) (1974).

86. *Id.*

87. The technical requirements for the form of the agreement are found in Treas. Reg. § 1.47-4(b)(2)(ii) (1974). For purposes of this provision the consent of a minor's legal or natural guardian on behalf of the minor is sufficient. Rev. Rul. 458, 1970-2 CUM. BULL. 3.

88. See *Inv. Rev. Code of 1954*, § 1372(b)(1).

89. Treas. Reg. § 1.47-4(b)(2)(i) (1974).

90. Treas. Reg. § 1.47-4(a)(1) (1974).

In *Tri-City Dr. Pepper Bottling Co.*,⁹¹ a taxpayer challenged the validity of section 1.47-4(b) of the Regulations, which is the basis for recapture absent the agreement. There, a corporate taxpayer elected under section 1372 to be taxed under Subchapter S, but the corporation and the shareholders failed to file a timely agreement under section 1.47-4(b)(2). Prior to the election the corporation had taken investment tax credit. The commissioner determined that under section 47(a)(1)⁹² the corporation was required to recapture the credits. The Tax Court held for the commissioner. The taxpayer also claimed it was relieved of liability for recapture under the section 47(b)⁹³ change-in-form exception. This contention was rejected since the effect of the election was only a change in the reporting and paying of income tax and not a change in the form of conducting business. The court held based on the Senate report⁹⁴ and Regulations section 1.47-3(f)(1) to the effect that the change-in-form exception requires that section 38 property be transferred from one entity to another. Thus, the change-in-form exception will not save a corporation from recapture upon election of Subchapter S.

B. *Disposition of Cessation in the Hands of the Corporation*

All property, including property acquired prior to the Subchapter S election and property acquired during the Subchapter S status, which is disposed of or otherwise ceases to be section 38 property, triggers recapture. If an agreement specified in Regulation section 1.47-4(b)(2) is filed, the corporation and the shareholders are jointly liable for pre-election property recapture.⁹⁵ Although the Regulations⁹⁶ affix this liability as if the property had ceased to be section 38 property on the last day of the taxable year preceding the first election year, the actual useful life is considered to have ended on the date of the actual disposition or cessation. The property acquired during a valid election year by the Subchapter S corporation, which is disposed of or otherwise ceases to be section 38 property in the hands of the Subchapter S corporation or a former Subchapter S corporation, is subject to recapture by each shareholder who was treated as a taxpayer with respect to such property in the year of acquisition.⁹⁷

91. 61 T.C. 508 (1974).

92. INT. REV. CODE OF 1954, § 47(a)(1).

93. *Id.* at § 47(b).

94. See note 23 and accompanying text *supra*.

95. Treas. Reg. § 1.47-4(b)(2) (1974). See note 86 and accompanying text *supra*.

96. *Id.*

97. Treas. Reg. § 1.47-4(a) (1974).

C. *Disposition of Subchapter S Stock*

1. The 66 2/3% — 33 1/3% Rule

If a shareholder's proportionate stock interest in a Subchapter S corporation is reduced by sale, gift, redemption, or any other disposition (except death), or by the issuance of more shares before the close of the estimated useful life of section 38 property held by the corporation, a recapture determination may be necessary. The test used to determine if the reduction in the stockholder's interest triggers recapture is the 66 2/3% - 33 1/3% rule. The rule is applied in the same manner discussed under the partnership section.⁹⁸ A reduction of the stockholder's interest in the corporation below 66 2/3 percent of his interest as of the end of the year in which the section 38 property was placed in service triggers recapture of the credit taken by the shareholder. Once there is recapture because of a reduction in stock interest below 66 2/3 percent, there is no further recapture unless the shareholder's interest is reduced below 33 1/3 percent of what it was at the end of the year the section 38 property was placed in service. A reduction below the specified percentages causes the section 38 property to cease to be section 38 property on the date of such reduction to the extent of the actual reduction in such shareholder's proportionate stock interest.⁹⁹ The question of recapture after a shareholder's interest has dropped below 33 1/3 percent is unsettled.¹⁰⁰ The better reasoned rule is that there is no further recapture until the shareholder's interest is disposed of completely. The actual useful life for the recapture determination begins on the date the property was placed in service and ends on the date of the reduction in stock interest that triggered the recapture.

In addition to direct ownership, a shareholder's proportionate stock interest includes any indirect ownership through another entity, where the other entity's basis in the stock is determined in whole or in part by reference to its basis in the hands of the transferor.¹⁰¹ Indirect ownership arises if a shareholder transferred all or part of his stock to a partnership or other corporation in exchange for an ownership interest in the transferee or to a trust in exchange for a beneficial interest therein. Because a Subchapter S corporation may

98. See pt. IV, § C(1) of this comment.

99. Treas. Reg. § 1.47-4(a)(2) (1974). For illustration: If a Subchapter S corporation has a qualified investment of \$60,000 with a ten year life, shareholders A and B each have \$2,100 credit (7% of \$30,000). In the first year A sells five shares of his ten, a fifty percent reduction. A's share of the qualified investment is reduced to \$15,000. A's tax is increased by a recapture of \$1,050.

100. See note 58 and accompanying text *supra*.

101. See note 59 and accompanying text *supra*.

have only individual shareholders, this indirect ownership rule has no application in the case of a presently electing Subchapter S corporation. The rule, however, may apply to a former Subchapter S corporation. A shareholder must retain his proportionate stock interest for the entire estimated useful life of the section 38 property. Thus, when applying the 66 2/3% - 33 1/3% with respect to a former Subchapter S corporation, the shareholder's direct and indirect ownership must be taken into account. For example, if A owns 100 shares of X corporation (a former Subchapter S corporation) and transfers 70 shares to Y corporation receiving 90 percent of the stock of Y, A is considered to own 30 percent of X directly and 63 percent (90 percent of 70) indirectly for a total of 93 percent.¹⁰² A's interest would have to drop below 66 2/3 percent for recapture to be triggered.

In *Charbonnet v. United States*,¹⁰³ the taxpayer, a shareholder in a Subchapter S corporation, sold enough stock to reduce his interest in the corporation below 66 2/3% of what it was when the section 38 property was placed in service. Recapture was triggered. The taxpayer asserted, quite erroneously, that the sale of stock came within the change-in-form exception even though the transaction was nothing more than a mere sale of stock to an outside party. The taxpayer focused his argument on the inconsistency between the substantial interest test of the change-in-form exception and the 66 2/3%-33 1/3% rule. He argued that if recapture is not triggered under the change-in-form exception then a fortiori there is no recapture for a mere reduction in interest below 66 2/3%. The court held that the taxpayer had not met the requirements of the change-in-form exception and did not reach the merits of the alleged inconsistency.

When a corporation plans to elect to be taxed under Subchapter S and to acquire investment credit property, the 66 2/3%-33 1/3% rule may be avoided by proper foresight. Any adjustments in the ownership interests should be made before the election. This is especially important if there are any plans to shift the interests or make gifts of more than one-third of the proportionate stock interests. Without this advance planning, any of these adjustments will cause recapture of any credits taken by the shareholders.

Even though the sale of Subchapter S stock may result in the recapture of investment credit, the purchaser of Subchapter S stock may not be allowed investment for his share of the used section 38

102. Treas. Reg. § 1.47-4(a)(2)(iii) (1974).

103. 320 F. Supp. 874 (D.C.La. 1971), *aff'd*, 455 F.2d 1195 (5th Cir. 1972).

property held by the corporation. Section 48(c) denies investment credit for used section 38 property if the property is used after the acquisition by someone who used it prior to its acquisition. If the Internal Revenue Service were to take the position that property held by a Subchapter S corporation is deemed to be used by all shareholders, then the purchaser of Subchapter S stock could not get investment credit for used section 38 property because the property would be used by the nonselling shareholders both before and after acquisition. However, this position would seem to be foreclosed by the decision in *Edward A. Moradian*, a case involving a partnership, which affords a sound basis for rejecting this argument.¹⁰⁴ The purchaser of Subchapter S stock is nevertheless limited by the provisions of section 48(c), whereby the purchaser of Subchapter S stock is not allowed investment credit for used section 38 property if he purchases less than 50% of the entire corporation.¹⁰⁵

D. *Termination of the Subchapter S Election*

Revocation or termination of the Subchapter S election does not automatically trigger recapture.¹⁰⁶ Where the revocation is for failure to comply with the requirements of section 1371, and does not involve a disposition of a shareholder's interest, then recapture is not triggered. However, if the termination accompanies a reduction in the shareholder's interest below 66 2/3% of what it was on the date the property was placed in service, then recapture is triggered. Where a former Subchapter S corporation disposes of investment credit property prior to the expiration of the estimated useful life of the property, recapture is triggered to the shareholders on the portion of the credit allowed them while the corporation was an electing corporation.¹⁰⁷ Thus a former Subchapter S corporation must avoid premature disposition of section 38 property and the shareholders must keep their direct and indirect ownership interests above two-thirds of what their interests were at the time the section 38 property was acquired, if they wish to avoid recapture.

E. *Reduction in Interest After a Change in Form — Which Continuity of Interest Test Controls?*

The discrepancy in the continuity of interest tests was pointed out in the *Charbonnet* case.¹⁰⁸ The taxpayer in that case, however,

104. See note 63 and accompanying text *supra*.

105. INT. REV. CODE OF 1954, § 179(d)(2)(A) which refers to INT. REV. CODE OF 1954, § 267 (b).

106. Treas. Reg. § 1.47-4(d) (1974).

107. See pt. IV, § B of this comment.

108. See note 103 and accompanying text *supra*.

was not in a situation where the two tests actually conflicted. The two tests are the same as those for a partnership.¹⁰⁹ Section 1.47-3(f)(5)(iv) of the Regulations controls the result in both instances. Where a shareholder reduces his interest while retaining a substantial interest to comply with the change-in-form exception, the 66 2/3% - 33 1/3% test of section 1.47-4(a)(2) of the Regulations controls and determines whether such a reduction will trigger recapture. The underlying theory is the same as for partnerships and it would be doubtful that a challenge to the Regulations in this area would have any greater success than in *Blevins*, which involved the same issue with regard to partnerships.¹¹⁰

V. CONCLUSION

Investment credit recapture is a problem that often may be avoided through careful planning of acquisitions and dispositions. If investment credit recapture cannot be avoided, one should at least be aware of the potential tax liability involved. Awareness of the potential recapture will cause negotiations to be adjusted to reflect the recapture that is inevitable.

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109. See pt. IV, § C(1) of this comment.

110. See note 77 and accompanying text *supra*.