Comment

Investment Credit and Recapture in Partnership Transactions

The investment credit is an important factor in transactions involving certain depreciable property, since it is a direct offset against federal income taxes. The disposition of investment credit property before the end of its useful life may trigger recapture of all or a portion of the investment credit taken with respect to such property. Partners should consider the possibility of investment credit recapture as a routine part of their planning and negotiation for every transaction involving partnership interests or partnership property.

After a summary of the general investment credit provisions, this comment discusses the application of the investment credit rules to particular transactions in the partnership context.

I. INVESTMENT CREDIT

Internal Revenue Code (Code) section 38 authorizes an investment credit, governed by the provisions in sections 46 through 48. The amount of the credit currently is ten percent of the qualified investment in section 38 property.

Section 48(a) defines section 38 property as depreciable property with an estimated useful life of at least three years, which is tangible personal property or certain other tangible property (excluding buildings). Both new and used section 38 property qual-

1. I.R.C. § 38(a). All section references in the text are to the 1954 Code unless otherwise indicated.
3. For other articles on the subject of investment credit recapture in partnership transactions, see Boyd, Taking Investment Credit on Property Deals Between Partner and Partnership, 47 J.TAX. 30 (1977); Galant, Partners, Subchapter S Shareholders and Beneficiaries—Beware: Investment Credit Recapture, 52 TAXES 417 (1974); Comment, Recapture of Investment Credit—Partnership and Subchapter S Corporation Transactions, 40 Mo. L. Rev. 90 (1975). See also 2 A. WILLIS, PARTNERSHIP TAXATION §§ 69.01 to .07 (2d ed., Supp. 1979).
ify for the credit. The cost of used section 38 property taken into account in determining the credit may not exceed $100,000 ($50,000 for a married person who files a separate return, unless the other spouse has no used section 38 property). The cost of used section 38 property does not include any carryover basis determined by reference to the adjusted basis of other property held at any time by the purchaser, such as occurs where there is a nontaxable trade-in of old property for the used section 38 property. There is an exception where the disposition of the other property triggers recapture of investment credit.

The credit must be taken in the year in which the section 38 property is placed in service. The amount of investment credit that may be taken annually is limited to the amount of the liability for tax for the taxable year that does not exceed $25,000 plus sixty percent of the liability for tax that exceeds $25,000. However, an unused credit may be carried back to each of the three preceding taxable years and, then, carried forward to each of the following seven taxable years.

Only the qualified investment is used in calculating the amount of the credit. The amount of the qualified investment depends on whether the section 38 property is new or used, and on the length of its estimated useful life. For new section 38 property, the applicable percentage of the basis is the qualified investment. For used section 38 property, the qualified investment is the applicable percentage of the cost as defined in section 48(c)(1). The applicable percentage for each of the above calculations is found in the following table from section 46(c)(2):

7. I.R.C. § 48(b) & (c).
12. I.R.C. § 46(a)(3). The percentage of the liability for tax in excess of $25,000 used in calculating the limit is scheduled to increase to 70% in 1980; to 80% in 1981; and to 90% in 1982. I.R.C. § 46(a)(3)(B). If a spouse files a separate return, the amount of $12,500 is substituted for $25,000 in determining the limit unless the other spouse is not entitled to any credit. I.R.C. § 46(a)(5).
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 but less than 7 years 66 2/3
7 years or more 100

The useful life of the property is the same estimated useful life used in computing the depreciation allowance under section 167.16

Section 47 provides for recapture of investment credit if, during the taxable year, any section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the end of its estimated useful life.

The amount of the recapture is the excess of the investment credit originally taken on the section 38 property over the amount of the credit that would have been taken had the actual period of use been used to calculate the qualified investment rather than the estimated useful life. The taxpayer must add the recaptured amount to his tax liability for the taxable year of the early disposition.17

There are four exceptions to the recapture provision of section 47(a). Section 47(b) excepts a transfer made by reason of death. This includes a transfer of property held in joint tenancy to the surviving joint tenant, the termination or assignment of a lease by reason of the death of the lessee, where the lessee had taken the credit, and the transfer of a partner's interest in a partnership by reason of the death of the partner. Potential recapture of any investment credit taken by a decedent during his life is eliminated at death, because he is deemed to have held his section 38 property for its entire estimated useful life.18

Section 47(b) also provides that a mere change in the form of conducting a trade or business shall not trigger investment credit recapture so long as the property is retained in the business as section 38 property and the taxpayer retains a substantial interest in the trade or business. The other two exceptions of section 47(b) are transactions to which either sections 381(a)19 or 374(c) applies.20

16. I.R.C. § 46(c) (2).
17. I.R.C. § 47(a) (1).
19. I.R.C. § 47(b) (2) relates to liquidations of subsidiaries and reorganizations.
20. I.R.C. § 47(b) (3) relates to exchanges under the final system plan of Con Rail.
II. PARTNERSHIP INVESTMENT CREDIT

A. Distributive Shares of Credit

The partnership as an entity is not subject to federal income taxation.\(^{21}\) Instead, each partner is taxed on his distributive share of various items of partnership income, gain, loss and deduction.\(^{22}\) Accordingly, each partner takes into account separately his share of the partnership's basis in new section 38 property and cost in used section 38 property. The estimated useful life of such property to each partner is the same as it is in the hands of the partnership.\(^{23}\) The credit is taken in the partner's taxable year within which ends the partnership year in which the property was placed in service.\(^{24}\) Each partner is entitled to the credit even though his adjusted basis in his partnership interest is zero, since the section 704(d) limitation applies only to partnership losses.

Each partner's share of section 38 property is determined according to his interest in the partnership's section 702(a)(8) profits, whether or not there is a profit or loss during the year the property is placed in service. If a partner's interest in such profits changes during the year, his interest on the date the section 38 property is placed into service shall control.\(^{25}\)

The regulations state two exceptions to the above rule, which permit the special allocation of shares in the basis or cost of section 38 property if the conditions of either exception is met.\(^{26}\) If all related items of income, gain, loss and deduction with respect to any item of partnership section 38 property are specially allocated in the same manner, and such allocations are recognized under section 704(a) and (b), then the special allocation for the date on which the property is placed in service shall be effective.\(^{27}\)

The second exception allows the partnership in its partnership agreement to provide for the non-allocation of any share of the ba-

\(^{21}\) I.R.C. § 701.

\(^{22}\) I.R.C. §§ 701, 702.


\(^{24}\) Id.

\(^{25}\) Treas. Reg. § 1.46-3(f)(2) (i) (1964), amended, T.D. 7126, 1971-2 C.B. 66. Commentators in 1 W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS §§ 10.04[2][a] & 11.03[1] (1967) [hereinafter cited as MCKEE], have relied on the pre-1976 law on the scope of section 706(c)(2)(B) and the legislative history of the 1976 change in § 706(c)(2)(B) to conclude that retroactive allocations among continuing partners is apparently still effective. Thus, if a partner's interest in section 702(a)(8) profits, at the date section 38 property is placed in service, is subsequently retroactively reduced, the latter interest shall control.


\(^{27}\) Id.
sis or cost of section 38 property to a partner whose interest in the partnership's section 702(a)(8) profits is five percent or less during the partnership's taxable year, and who will retire under the agreement, during the taxable year or within seven years thereafter.\textsuperscript{28}

Each partner is limited to $100,000 as the amount of the cost of used section 38 property that he may take into account in determining his qualified investment.\textsuperscript{29} A limit of $100,000 is applied at the partnership level, before application at the partner level.\textsuperscript{30} If the partnership acquires and places in service more than $100,000 of used section 38 property in the taxable year, only $100,000 of the cost may be allocated to the partners, even though each partner does not exceed the $100,000 limit taking into account his share of the partnership's cost and the cost of other used section 38 property allowed to him.\textsuperscript{31}

Where the partnership has exceeded its limit of used section 38 property, it must make a selection of used section 38 property that shall be taken into account by the partners.\textsuperscript{32} The entire cost of a particular property must be taken into consideration unless, as a result of the selection of such particular property, the $100,000 limit is exceeded.\textsuperscript{33} Each partner who then exceeds his applicable limit must make a selection of used section 38 property from those placed in service by him in his own business, the share apportioned to him by an electing small business corporation, trust or estate and his share of section 38 property selected by the partnership.\textsuperscript{34} He must take into account the entire cost of a particular property or an entire share of the cost of a particular partnership property unless the limit is exceeded by a particular selection. The partner must maintain records specifically identifying the items of property selected.\textsuperscript{35}

To illustrate this procedure, assume a partnership purchases and places in service used section 38 property \( A \), at a cost of $60,000, and used section 38 property \( B \), at a cost of $50,000. The partnership may select for investment credit purposes either the entire cost of property \( A \) and $40,000 of the cost of property \( B \), or

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{29} I.R.C. § 48(c)(2)(A). \textit{See} text accompanying notes 8 & 9 supra.
\item \textsuperscript{30} I.R.C. § 48(c)(2)(D).
\item \textsuperscript{31} I.R.C. § 48(c)(2)(A), Treas. Reg. § 1.48-3(c)(3) (1964).
\item \textsuperscript{32} Treas. Reg. § 1.48-3(c)(3) (1964).
\item \textsuperscript{33} Treas. Reg. § 1.48-3(c)(4)(ii) (1964).
\item \textsuperscript{34} Treas. Reg. § 1.48(c)(1) (1964).
\item \textsuperscript{35} Treas. Reg. § 1.48-3(c)(4)(ii) (1964). \textit{See} Treas. Reg. § 1.48-3(c)(5) ex. (2) (1954). Note that the regulations do not reflect the change from the $50,000 limit to the $100,000 limit now allowed by I.R.C. § 48(c)(2)(A). Also note that Treas. Reg. § 1.47-3(d) (1967) allows reselection of used section 38 property where the credit on selected used section 38 property has been recaptured.
\end{enumerate}
\end{footnotesize}
the entire cost of property $B$ and $50,000$ of the cost of property $A$. Assuming the partnership made the latter selection and one of the partners, whose interest in the partnership profits is fifty percent, had also purchased at a cost of $70,000$ used section 38 property for his sole proprietorship, he would select the property to be taken into account from among his $70,000$ cost of property in his own business and his fifty percent share of the entire cost of property $B$ and $50,000$ of the cost of property $A$. For example, he could select the $70,000$ cost of used section 38 property used in his own business, plus his $25,000$ share of the entire cost of property $B$ and $5,000$ of his share of the cost of property $A$.

B. Leasing Section 38 Property

Congress has placed restrictions on the availability of investment credit to non-corporate lessors under section 46(e)(3). While section 46(e)(3) allows corporate partners investment credit for their share of the basis or cost of section 38 property of which the partnership is a lessor, the non-corporate partners (including electing small business corporations) will not be allowed a credit on such property unless:

(A) the property subject to the lease has been manufactured or produced by the lessor, or

(B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessee solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.\(^36\)

Note that interest, taxes and depreciation are not solely section 162 expenses. However, the regulations provide that the restrictions will not apply to property that was used by the taxpayer in his trade or business (other than the leasing of property) for at least two years preceding the date on which such property is leased.\(^37\) A non-corporate lessor that is denied the investment credit under section 46(e)(3) could pass all or a portion of the investment credit to the lessee by electing to have the lessee treated as the purchaser, where the property is new and would be section 38 property in the hands of the lessor.\(^38\)

36. I.R.C. § 46(e)(3).
C. Partnership Dispositions of Section 38 Property

If section 38 property of the partnership is disposed of, or ceases to be section 38 property in the hands of the partnership before the expiration of the estimated useful life used in computing the property's qualified investment, then each partner who had taken investment credit on such property is subject to the recapture provisions of section 47 (a)(1) with respect to his share of the qualified investment. The recapture determination takes into account any previous recapture determination made with respect to a partner in connection with the same property.\(^{39}\) Under section 47(c), tax increases due to recapture of investment credit may not be offset by credits otherwise allowed by sections 31 through 45, but must be paid in the year incurred.\(^{40}\) If the credit being recaptured was taken on the cost of used section 38 property in a taxable year when the cost of used section 38 properties with respect to a partner exceeded $100,000, that partner may re-select the cost to be taken into account from the unselected used section 38 property originally available to him in that year.\(^{41}\)

The regulations provide that the term "disposition" includes a sale in a sale-and-leaseback transaction, a transfer upon the foreclosure of a security interest, and a gift.\(^{42}\) Other transactions commonly considered to be dispositions include destruction of property by casualty or theft, retirement from use, abandonment, reduction in basis from election involving realized gain from a discharge of indebtedness and a like-kind exchange under section 1031. Of course, these dispositions only result in recapture of investment credit if they occur before the estimated useful life used in determining the qualified investment.\(^{43}\)

III. CONTRIBUTION OF SECTION 38 PROPERTY TO A PARTNERSHIP

Generally, a sale or exchange of section 38 property by a partner to a partnership triggers investment credit recapture under section 47(a)(1).\(^{44}\) However, a contribution under section 721 by a partner of section 38 property to a partnership does not trigger investment credit recapture if it meets the conditions of a mere change in the form of conducting the trade or business.\(^{45}\) The reg-

\(^{39}\) Treas. Reg. § 1.47-b(a)(1) (1967). See text accompanying note 17 supra, for computation of the amount of recaptured credit.

\(^{40}\) I.R.C. § 47(c).

\(^{41}\) Treas. Reg. § 1.47-3(d) (1967).


\(^{43}\) I.R.C. § 47(a)(1).

\(^{44}\) See § IV-A of text infra, for discussion of this transaction.

\(^{45}\) I.R.C. § 47(b).
ulations list four conditions that must be satisfied.\textsuperscript{46} First, the property must be retained by the partnership as section 38 property in the same trade or business.\textsuperscript{47} Second, the transferor of the property must retain a substantial interest in such trade or business.\textsuperscript{48} Third, substantially all the assets (whether or not section 38 property) necessary to operate such trade or business must be transferred to the partnership with the section 38 property.\textsuperscript{49} Fourth, the basis of the section 38 property in the partnership's hands must be determined in whole or in part by reference to its basis in the contributing partner's hands.\textsuperscript{50}

If the contributed section 38 property is disposed of or ceases to be section 38 property in the hands of the partnership before the expiration of the estimated useful life considered in computing the qualified investment, then the contributing partner will be subject to investment credit recapture, since he stays directly liable for subsequent investment credit recapture on the contributed property.\textsuperscript{51}

The regulations provide that a partner will be considered as retaining a substantial interest in the trade or business if his interest is substantial in relation to the total interest of all persons, or is equal to or greater than his interest prior to the change in form.\textsuperscript{52} Since a contributing partner will not commonly retain an interest which is equal to or greater than it was before the transfer, the significant test is whether his interest, after the transfer, is substantial in relation to the interest of all the partners.

Two examples in the regulations indicate that the exchange of a total interest in assets for either a fifty or forty-five percent interest is substantial in relation to the interest of all persons. The first example involves the transfer of all the assets of a sole proprietorship to a corporation for a forty-five percent stock interest.\textsuperscript{53} In the second example, a corporation transfers all the assets used in one of its businesses to a partnership in exchange for a fifty percent partnership interest. Neither of these transfers triggers recapture.\textsuperscript{54}

The Tax Court in the case of \textit{James Soares}\textsuperscript{55} indicates that a 7.22 percent retained interest is not substantial in relation to the

\begin{itemize}
\item \textsuperscript{46} Treas. Reg. § 1.47-3(f)(1)(ii) (1967).
\item \textsuperscript{47} Treas. Reg. § 1.47-3(f)(1)(ii)(a) (1967).
\item \textsuperscript{48} Treas. Reg. § 1.47-3(f)(1)(ii)(b) (1967).
\item \textsuperscript{49} Treas. Reg. § 1.47-3(f)(1)(ii)(c) (1967).
\item \textsuperscript{50} Treas. Reg. § 1.47-3(f)(1)(ii)(d) (1967). \textit{But see} note 103 infra.
\item \textsuperscript{51} Treas. Reg. § 1.47-3(f)(5)(i) (1967).
\item \textsuperscript{52} Treas. Reg. § 1.47-3(f)(2) (1967).
\item \textsuperscript{53} Treas. Reg. § 1.47-3(f)(6) ex. (1) (1967).
\item \textsuperscript{54} Treas. Reg. § 1.47-3(f)(6) ex. (5) (1967).
\item \textsuperscript{55} 50 T.C. 909 (1968).
\end{itemize}
total interest of all persons, and that the percentage interest, rather than the value of the interest, is the interest that must be substantial. In the case, a sole proprietor formed a partnership with a corporation, transferring his business assets for a forty-eight percent partnership interest which he exchanged six months later, for 7.22 percent of the stock in the corporation.

However, the case, as well as the regulations, leaves unanswered the question of how much below forty-five percent an interest can be and still be considered as substantial.

If the contributing partner's partnership interest subsequently ceases to be substantial, then the transferred property ceases to be section 38 property with respect to the partner, and he must make a recapture determination under section 47(a). His partnership interest could be reduced by events such as a sale of a substantial portion of his interest or by the entry of a new partner which results in a substantial reduction in the other partner's interest.

IV. PARTICULAR PROPERTY AND PARTNERSHIP INTEREST TRANSACTIONS

A. Sales of Section 38 Property Among Partners and Partnerships

When a partner sells section 38 property to the partnership or the partnership sells section 38 property to a partner, the transferee will be required to make a recapture determination in accordance with section 47(a). However, the question of whether the transferee may take investment credit on the used section 38 property is a subject of controversy.

Section 48(c)(1) provides in part that:

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 section 179(d)(2)(A) or (B) to a person who used such property before such acquisition).

Section 179(d)(2)(A) and (B) applies the relationships causing disallowance of loss listed in section 267 and section 707(b) as well as component members of a controlled group. Thus, in a sale between a partnership and a partner, who owns, directly or indi-

56. Id. at 913.
57. Id. at 910.
59. Where the partnership is the transferor, each partner will make the recapture determination. See text accompanying note 39 supra.
60. See Boyd, supra note 3, for an in-depth analysis of this section.
61. I.R.C. § 48(c)(1). However, Treas. Reg. § 1.48-3(a)(2)(ii)(b) (1994) provides that "property shall not be considered as used by a person before its acquisition if such property was used only on a casual basis by such person."
more than fifty percent of the partnership capital or profits interest, the transferee may not take investment credit on the used section 38 property. Also, the credit on used section 38 property is denied to the transferee in a sale between two partnerships in which the same persons own, directly or indirectly, more than fifty percent of the capital or profits interests.

However, where the sale takes place between a partnership and a less-than-fifty-percent partner, the result is not certain. The regulations provide that for the purpose of deciding whether section 38 property is used before and after acquisition by the same person, any property used by a partnership will be considered as used by each partner. The regulations illustrate the application of such a sale with an example in which a partner with a one-third partnership interest sells section 38 property that he has been using in his sole proprietorship to the partnership. The property is not treated as used section 38 property by the partnership since it is used by the same person (the contributing partner) both before and after acquisition. The example goes on to state that a sale by the partnership to the one-third partner would receive similar treatment.

The Tax Court has three times held the regulation invalid in its attempt to impute the use of partnership property to each partner. One of the cases was affirmed by the Fifth Circuit Court of Appeals.

In Moradian, Nick Hagopian and Edward Moradian were equal partners in a grape growing operation, and were tenants in common of the real estate and grapevines used by the partnership. In 1964, Hagopian sold his one-half interest in both the partnership and the realty and grapevines to Edward's wife, Georgia Moradian, who claimed investment credit on the grapevines. The Service argued that the credit was not allowed under section 48(c)(1) since it was used both before and after the acquisition by the same person, imputing the use of the grapevines by the partnership to Edward as a partner. In a decision with six judges...
dissenting, the Tax Court held that Georgia was entitled to the credit, by adopting an entity approach to the application of section 48(c)(1).\textsuperscript{72} In declaring the regulation invalid to the extent it attributes the use of property by the partnership to each partner, the court reasoned that such attribution would render the parenthetical portion of section 48(c)(1) superfluous insofar as it relates to partnerships.\textsuperscript{73} That portion refers to section 179(d)(2)(A) which in turn refers to section 707(b), resulting in the disallowance of investment credit to the transferee in sales between a more-than-fifty-percent partner and his partnership and between two partnerships with more than fifty percent of common control. If a sale by a partner with a fifty percent or less interest to his partnership is also denied investment credit, then the “more-than-fifty-percent” rule would be unnecessary.\textsuperscript{74} Also, the court held that the term “person” in section 48(c)(1) included a partnership according to the definition of “person” in section 7701(a)(1).\textsuperscript{75} Since the partnership of Hagopian and Moradian was a different entity from the partnership of the two Moradians, the grapevines were not used by the same person both before and after the acquisition by Georgia.\textsuperscript{76}

The Service nonacquiesced in the \textit{Moradian} decision.\textsuperscript{77} Also, the Service stated its intention in Revenue Ruling 74-64\textsuperscript{78} to continue to treat each partner as users of property used by the partnership.

However, the next time the Tax Court was presented a similar case, it again held in favor of the taxpayer and was affirmed by the Fifth Circuit.\textsuperscript{79} In \textit{Holloman v. Commissioner},\textsuperscript{80} the taxpayer was a dentist in an equal partnership with another dentist, B.J. Blankenship. Blankenship owned certain dental equipment which he leased to the partnership during the nine months of its existence. The partnership terminated when the the taxpayer purchased both Blankenship's interest in the partnership and all of his dental equipment. He claimed investment credit on the used dental equipment, which was challenged by the Service on the same
grounds as in *Moradian*. The court followed its holding in *Moradian*, and held that the partnership in Holloman and Blankenship was a entity different than Holloman's sole proprietorship.

In both *Moradian* and *Holloman*, the transferor of the property also sold his fifty percent interest in the partnership, thus terminating the partnership under section 708(b). Consequently, in neither case was the old partnership considered to continue in existence, so that under the entity approach, the new partnership in *Moradian* and the sole proprietorship in *Holloman* were definitely new entities. In neither case did the facts necessitate an opinion on whether the investment credit would be allowed to the transferee where there is not a simultaneous sale of the separately owned property, which is used by the partnership before and after the sale, and fifty percent or more of an interest in the partnership. For instance, if in *Holloman* there had been another partner, with each having a one-third interest, and Blankenship had sold his one-third interest and the dental equipment to the other two partners, who continued to use it in their partnership, there would not have been a termination under section 708(b)(1)(B) and arguably the same person, the continuing partnership, would be using the dental equipment before and after the acquisition. A similar situation would exist where Blankenship, under the actual *Holloman* facts, sold less than all of his partnership interest. Besides the "same person" argument, even if the continuing partnership were not treated as being the same entity as the old partnership, a "related person" argument could be used to deny investment credit. Section 48(c)(1) denies section 38 treatment to property used by a person with a relationship described in section 179(d)(2)(A) with a person who used the property before acquisition. Section 179(d)(2)(A) refers to section 707(b), with the result that credit would not be allowed to a sale where the property is used after the acquisition by a partnership which is more-than-fifty-percent owned by the same partners who own more than fifty percent of the partnership which used the property before the acquisition. That would be the case where there is not a simultaneous sale of a fifty percent interest and separately owned property which is used by the partnership before and after the sale.

A situation analogous to that in *Holloman* is one where a partner with a fifty percent or less interest in a partnership sells to that partnership section 38 property that was used by a different enterprise, such as a sole proprietorship. Applying section 48(c)(1) and

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82. Holloman v. Commissioner, 551 F.2d at 1357.
the regulation that attributes the partnership's use of section 38 property to each partner, the property would not be treated as section 38 property in the partnership's hands since it is used both before and after the sale by the selling partner. This fact pattern was presented for the Tax Court's decision in Steven M. Kipperman.

Kipperman owned a one-half interest in law books and furnishings with Silber, a lawyer with whom he shared office space. Kipperman formed an equal partnership with two other attorneys and sold his interest in the books and furnishings to the partnership. The partnership sold its interest in the furnishings to Silber and each bought the other's interests in some of the books. Kipperman recaptured investment credit he had previously taken, but claimed his share of investment credit on the section 38 property bought by the partnership. The Service disallowed the credit as to the property acquired from Kipperman. However, the Tax Court again applied the entity approach, rather than the aggregate approach of the regulations, and held for Kipperman. The same holding should result where the partnership, which does not terminate as in Holloman, sells a section 38 property to a partner with a fifty percent or less partnership interest, if it is not subsequently used by the partnership.

If the Tax Court continues to apply the entity approach, then another transaction where investment credit should be allowed to the transferee is a sale of section 38 property between two partnerships where there is not the identity of partners between the two partnerships with regard to more than fifty percent of the capital or profits interest, since they are separate entities and not covered by the "related person" test in section 707(b)(1)(B).

Despite the three cases holding against it, the Internal Revenue Service will continue to treat property used by a partnership as used by each partner in applying section 48(c)(1). So, those partnerships planning transactions covered by that rule risk litigation to gain the benefit of investment credit.

84. 36 T.C.M. 146 (1977).
85. Id. at 146-47.
86. Id.
87. Id. at 147.
88. Id.
89. Id. at 148-49.
90. 551 F.2d 987 (5th Cir. 1977), affg, T.C.M. 1354 (1975).
B. Sale or Other Reduction of Partnership Interest

The regulations provide that if a partner has taken the basis or cost of partnership section 38 property into account in computing his qualified investment and, before the close of such property's estimated useful life, his proportionate interest in the section 702(a) (8) profits (or in a particular item of property) is reduced below a certain percentage, then on that date such section 38 property will cease to be section 38 property in his hands to the extent of the actual reduction and a recapture determination will have to be made. Such reduction may be caused by a sale, a change in the partnership agreement, the admission of a new partner, a gift, or other transactions. Direct and indirect interests are taken into account for this purpose.

In order to trigger recapture, the partner's interest must be reduced below 66 2/3 percent of the amount as of the year the section 38 property was put in service. At that time, a recapture determination is made to the extent of the entire reduction in the partnership interest. Once any property ceases to be section 38 property due to a reduction below the 66 2/3 percent threshold, there is no further recapture until the partner's interest drops below 33 1/3 percent of the same amount used in the previous threshold, at which time another recapture determination must be made on the property to the extent of the reduction in the interest since the last determination. Thus, if a partner with a sixty percent partnership interest sells a ten percent interest, than later a twenty percent interest, he will have a recapture determination after the latter sale to the extent of fifty percent of the basis or cost of the applicable section 38 property, since he has sold fifty percent of his sixty percent interest. If he later sells another five percent interest in the partnership, there would not be a recapture determination since he has not dropped below the 33 1/3 percent threshold, which in his case is a twenty percent partnership interest.

In some tax shelter partnerships, the partnership agreement will provide for a change in the partner's interests in section 702(a) (8) profits upon the happening of a condition. A private letter ruling indicates that recapture will not be triggered until a part-

92. Treas. Reg. § 1.47-6(a) (2) (i) (b) (1967).
93. Treas. Reg. § 1.47-6(a) (2) (A) & (B) (1967); id. § 1.47-2(a) (1) (1967). See text accompanying notes 117, 120, 121, 123, 126 infra, for discussion of specific partnership interest transactions, including exceptions to the recapture rules.
94. Treas. Reg. § 1.47-6(a) (2) (iii) (1967).
95. Treas. Reg. § 1.47-6(a) (2) (ii) (1967).
96. Treas. Reg. § 1.47-6(a) (2) (i) (1967).
97. Treas. Reg. § 1.47-6(a) (2) (ii) (1967).
ner's interest is reduced below $66\frac{2}{3}$ percent of the amount at the
time the section 38 property was placed in service.\textsuperscript{98}

The purchaser of a partnership interest is not entitled to investment
credit with respect to partnership assets, regardless of
whether he is entitled to adjust the basis of partnership assets
under section 743.\textsuperscript{99} One commentator has reasoned that since
each partner holds an undivided interest in the whole of property
held in tenancy in partnership, rather than title to any specific por-
tion of the property, a sale of an interest in partnership capital or
profits is not treated as a sale of the partner's interest in each spe-
cific partnership asset.\textsuperscript{100} The issue has not yet been litigated.

An argument might be made that since the selling partner is
potentially subject to recapture on a determinable share of section
38 property, then for investment credit purposes, a partner should
be considered as selling interests in specific partnership section 38
assets. The Regulations appear to accept this approach, since the
reason given for denying investment credit after an acquisition of a
partnership interest is that the property is used by the same per-
sons (the other partners) both before and after the acquisition.\textsuperscript{101}

If a purchaser is treated as having purchased fractional shares
in partnership property, then he will still be denied investment
credit according to the regulations as stated above. However,
under the rationale of \textit{Moradian},\textsuperscript{102} an investment credit should be
available where the sale is of a fifty-or-more-percent interest, since
that would cause termination of the partnership under section
708(b)(1)(B) and consequently a different entity would be using
the property after acquisition. In contrast, on the sale of a less-
than-fifty-percent interest, the same entity (the continuing part-
nership) will be using the property both before and after the sale,
or alternatively, the view could be taken that the property was
used after acquisition by a partnership of which more than fifty
percent of the interests are owned by the same persons who
owned more than fifty percent of the partnership that used the
property before acquisition.

\textsuperscript{98} Priv. Let. Rul. 7806070 (Nov. 14, 1977). Investment credit recapture was not
triggered upon “flip-flop” of limited partner's interest in profits and losses
from $90\%$ to $70\%$, since, in this instance, the $66\frac{2}{3}\%$ threshold was not
passed.


\textsuperscript{100} Boyd, \textit{supra} note 3, at 31.

\textsuperscript{101} Treas. Reg. § 1A8-3 (a)(3) ex. (5) (1964). However, this regulation's validity is
in doubt, as discussed in the text accompanying notes 67-91 \textit{supra}.

\textsuperscript{102} 53 T.C. 207 (1969). \textit{See} text accompanying note 68 \textit{supra}. 
C. Lease of Section 38 Property Between Partner and Partnership

According to the regulations, the mere leasing of section 38 property by the lessor who had taken investment credit with respect to the property does not constitute a disposition for the recapture provisions of section 47(a)(1). \(^\text{103}\)

However, section 46(e)(3) places restrictions on the availability of investment credit to non-corporate lessors, as discussed earlier. \(^\text{104}\) Since partners may transact business with their partnership as ones who are not partners under section 707, the same rules on non-corporate lessors which apply to transactions between other third parties and a partnership or partner should apply to a lease between a partnership and a partner. The potential abuse that exists with sales of property between partnerships and partners is not present in the lease context.

If a partner who has been leasing section 38 property from his partnership later buys it, he could not claim investment credit since under section 48(c)(1) property will not be treated as section 38 property if used both before and after the acquisition by the same person. \(^\text{105}\) The same result would hold true where a partnership leased section 38 property from a partner before purchasing it.

D. Distribution to Partners of Section 38 Property

When partnership section 38 property is distributed to a partner prior to the end of its estimated useful life which was taken into account in computing investment credit, recapture under section 47(a)(1) will generally be triggered with respect to the non-distributee partners since they had a reduction in their proportionate interest in a particular item of property. \(^\text{106}\) The regulations are not clear on the result to the distributee (or distributees, where more than one partner receives a distribution of his proportionate share of section 38 property). One commentator has concluded that recapture will apparently be triggered with respect to the distributee under the language of Treasury Regulation section 1.47-6(a)(1). \(^\text{107}\) Another commentator has concluded that as long as a

\(^\text{103}\) Treas. Reg. § 1.47-2(b)(1) (1967).
\(^\text{104}\) See text on leasing section 38 property at note 36 supra.
\(^\text{106}\) Treas. Reg. § 1.47-6(a)(2)(b) (1967).
\(^\text{107}\) 1 McKee, supra note 25, § 19.07. Treas. Reg. § 1.47-6(a)(1) (1967), reads in part:

If a partnership disposes of any partnership section 38 property (or if any partnership section 38 property otherwise ceases to be section 38 property in the hands of the partnership) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to each partner who is
partner receives at least his proportionate share of a specific section 38 property, then no recapture will be triggered with respect to him,\textsuperscript{108} since he experienced no reduction in his proportionate interest.\textsuperscript{109}

Another question which is not answered in the code nor regulations is whether section 38 property, which is treated as part of a fictional distribution and sale and exchange under section 751, triggers recapture. One commentator believes that the effect of section 751(b) should be limited by its statutory purpose to the recognition of gain or loss and the determination of a new basis for the partnership and the distributee with respect to the hypothetically exchanged property.\textsuperscript{110} If the hypothetical sale is effective for investment credit purposes, then the problem discussed earlier as to the availability of investment credit on sales between partnerships and partners will have to be faced.\textsuperscript{111}

E. Contribution of Partnership Property to a Corporation

The section 47(a)(1) recapture provisions may apply when section 38 property is contributed to a corporation by a partnership unless the transfer meets the requirements of a mere change in the form of conducting a trade or business, which are: 1) the section 38 property must be retained in the trade or business by the corporation; 2) the partners must retain a substantial interest in the trade or business; 3) substantially all the assets necessary to operate the trade or business must be transferred with the section 38 property; and 4) the basis of the section 38 property in the corporation's hands must be determined in whole or in part by reference to the basis of such property in the hands of the partnership.\textsuperscript{112}

If the corporation disposes of the contributed section 38 property (or the property otherwise ceases to be section 38 property in the corporation's hands), before the close of its estimated useful life used in calculating the qualified investment, then the partners
treated, under paragraph (f) of § 1.46-3 as a taxpayer with respect to the property.

\textit{See} text accompanying note 39 \textit{supra}, for the requirements of the exception for a mere change in the form of conducting business. \textit{See also} notes 133-34 infra, for further discussion of the carryover basis requirement of the above exception.

\textsuperscript{108} 2 A. \textsc{Willis}, \textit{supra} note 3, § 69.08.
\textsuperscript{109} Treas. Reg. § 1.47-6(a)(2)(b) (1967).
\textsuperscript{110} 1 \textsc{Mckee}, \textit{supra} note 25, § 21.01[3].
\textsuperscript{111} \textit{See} text accompanying notes 59-93 \textit{supra}.
\textsuperscript{112} Treas. Reg. § 1.47-3(f)(1) (1967). \textit{See} text accompanying notes 44-58 \textit{supra}, for more discussion of the requirements of mere change in the form of conducting a trade or business.
will have to make a recapture determination under section 47(a)(1). If any partner fails to retain a substantial interest in the corporation during the estimated useful life of the section 38 property taken into account in determining qualified investment, he will have to make a recapture determination. Also, if any partner’s interest in the corporation is reduced, but he retains a substantial interest, there will still be a recapture determination if the percentage reduction limitations regarding partnership interests are exceeded.

There are three alternative methods to incorporate a partnership’s business under section 351. As discussed above, the partnership could transfer all of its assets to the corporation in exchange for stock and securities of the corporation, then liquidate the partnership. Alternatively, the partnership could distribute its assets in liquidation to its partners, who then would transfer the assets to the corporation in exchange for its stock and securities. Also, the partners could transfer their partnership interests to the corporation for its stock and securities. However, Revenue Ruling 70-2391 holds all three methods to be a contribution to the corporation of the assets by the partnership, with a subsequent liquidation. This holding is based on the premise that the federal income tax consequences are the same for all three alternatives. This premise is questionable. At least for investment credit purposes, a partnership should transfer its assets to the corporation rather than liquidating first, due to the risk of recapture upon liquidation of a partnership.

F. Contribution of Partnership Interests to a Corporation

Usually, if a partner’s proportionate interest in the section 702(a)(8) profits of the partnership are reduced below certain percentage thresholds before the close of the estimated useful life of section 38 property that he took into account in computing his qualified investment in the property, there will be a recapture determination for the property to the extent of the reduction in interest. However, in determining a partner’s interest in section 702(a)(8) profits, the partner is considered to own any interest in such a partnership which he owns directly or indirectly, through

117. See 1 MCKEE, supra note 25, § 17.03[1].
118. See text accompanying note 107 supra.
ownership in other entities, provided such entities' basis in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the partner. Therefore, if a partner transfers all or part of his partnership interest to a corporation in a section 351 exchange, he will take into account the indirect interest in the partnership attributable to his stock interest in determining the reduction in his partnership interest. The regulations illustrate this rule with the example of a partner who transfers his twenty percent interest in partnership general profits to a corporation in a section 351 exchange for all of the stock of the corporation. That partner is considered to own the twenty percent partnership interest. If he had received less than all the stock in a section 351 exchange, for example sixty percent, then he would be considered the owner of a proportionate share of the partnership interest, namely a twelve percent partnership interest.

G. Contribution of Partnership Interest to Another Partnership

Where a partner contributes his interest in a partnership's general profits to another partnership in a section 721 exchange, he shall still be treated as the owner of the partnership interest to the extent of his partnership interest in the transferee partnership.

H. Distribution of Partnership Interests by a Corporation or Another Partnership

Where a partnership or a corporation distributes an interest in another partnership, there may be an investment credit recapture determination under section 47(a)(1) if the transferor's partnership interest is reduced past certain percentage thresholds. The protection afforded the transferor of a partnership interest in a section 351 transfer to a corporation or a section 721 transfer to a partnership does not apply under these circumstances since the distributing entity will not retain an interest through its transferee.

I. Death of a Partner

The recapture provisions of section 47(a)(1) do not apply to the transfer of a partner's interest in a partnership by reason of the

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121. Id.
122. Id. For discussion of the similar treatment of a section 351 contribution of partnership interest to a corporation, see § IV-E of text supra.
death of such partner. Potential recapture of any investment credit taken by a partner during his life is eliminated at death, since he is deemed to have held his section 38 property for its entire estimated useful life.\textsuperscript{125}

Where an estate or trust acquires a partnership interest, the qualified investment for section 38 property purchased by the partnership shall be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each. The limits on the amount of credit that a taxpayer may use under section 46(a)(3)(A) and (B) as applied to an estate or trust is reduced on the basis of its allocable share of qualified investment.\textsuperscript{126}

When a partnership interest is distributed by an estate before the close of the estimated useful life of section 38 property on which the estate received an investment credit, there will be a recapture determination to the extent of the reduction of the interest, after certain percentage thresholds are passed.\textsuperscript{127}

J. Like-Kind Exchange of Partnership Interests

If a section 1031 like-kind exchange of partnership interests is made, there will be a recapture determination if the partner’s interest is reduced below certain percentage thresholds.\textsuperscript{128}

K. Constructive Termination of the Partnership Under Section 708(b)(1)(B)

When there has been a sale or exchange of fifty percent or more of the total interest in partnership capital and profits within a twelve month period, the partnership will be considered terminated under section 708(b)(1)(B). The selling partner or partners will be subject to recapture determinations if their interests are reduced below certain percentage thresholds, which they usually would be under these circumstances.\textsuperscript{129}

However, the treatment of partners who continue the business in a reconstituted partnership is uncertain. One commentator has suggested that there would not be any recapture in connection with the constructive distribution of partnership property in a section 708(b)(1)(B) termination, since they would probably receive a proportionate undivided share of each asset in the constructive distribution, including section 38 property. Therefore their inter-

\textsuperscript{125} I.R.C. § 47(b)(1); Treas. Reg. § 1.47-3(b)(1) (1967).
\textsuperscript{126} I.R.C. § 46(f).
\textsuperscript{127} Treas. Reg. § 1.47-6(a)(2) (1967). \textit{See} text accompanying notes 93-102 supra.
\textsuperscript{128} \textit{Id.}
\textsuperscript{129} \textit{Id.}
ests in such property would not be reduced below the 66 2/3 percent threshold.\textsuperscript{130}

Another commentator concludes that there is recapture to the continuing partners since the constructive distribution will cause the property to cease to be section 38 property in the hands of the partnership.\textsuperscript{131} That commentator doubts that the exception for a mere change in the form of conducting a business would apply since one of the requirements is that the basis of the property in the transferee's hands must be a carryover basis, which it is not under the termination, since under section 732(b) the basis of the property is determined with reference to the distributee's basis in his partnership interest.\textsuperscript{132} However, the Tax Court has recently raised a question in the corporate liquidation setting as to the validity of the carryover basis requirement of the regulations.\textsuperscript{133} When presented with this question, again involving a corporate li-

\begin{itemize}
\item[130.] Treas. Reg. § 1.47-6(a)(2) (1967); 2 A. Willis, supra note 3, § 31.12.
\item[131.] 1 McKee, supra note 25, § 12.05[2] [g].
\item[132.] Treas. Reg. § 1.47-6(a) (1) (1967); 1 McKee, supra note 25, § 12.05[2] [g]. Note that in I.R.C. § 1245(b)(6), section 1245 property is deemed to be carry-over basis property for purposes of depreciation recapture, thus restricting immediate recapture to the amount of gain recognized to the transferor on the liquidation contribution.
\item[133.] Petitioners in Eugene A. Ramm, 72 T.C. No. 57 (1979), argued that the requirement of Treas. Reg. § 1.47-3(f)(1)(ii)(d) (1967), (as amended 1972) was invalid as contrary to congressional intent behind I.R.C. § 47(b), which reads in part:
\begin{quote}
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.
\end{quote}
The case involved a distribution in liquidation of an electing small business corporation, with basis determined under the substituted basis provision of I.R.C. § 334(c) which is similar to the partnership provision in I.R.C. § 732(b).

While the court did not pass on the merits of that argument, it did state that:
\begin{quote}
[W]e think that there is an issue as to whether the condition imposed by paragraph (d) of section 1.47-3(f)(1)(ii) is consistent with the congressional intent behind the "mere change in the form of conducting the trade or business" exception in section 47(b). Since we decide this case on an alternative ground, we do not resolve that issue here.
\end{quote}

72 T.C. at —. The court decided against the taxpayers on the ground that the same trade or business was not carried on after the liquidation, since the stockholders each began independent business operations rather than collectively employing the assets of the corporation for a productive purpose. This same result could result in recapture for a terminated partnership if substantially all the assets needed for the trade of the old partnership are not transferred to the continuing partners.
uidation, one district court held the regulation invalid.\textsuperscript{134}

There is a difference where the partnership is treated as terminated under the section 708(b)(2)(A) merger provision. A private letter ruling\textsuperscript{135} indicates that under those circumstances there will be no recapture to the continuing partners, who had the same proportionate interests in each of the merged partnerships and in the resulting partnership, since the partnership is treated as having distributed all its assets and liabilities to the resulting partnership in exchange for an interest in such partnership, which is then distributed out to the partners. Thus, the property did not receive a basis based on section 732(b).\textsuperscript{136}

V. CONCLUSION

The investment credit usually results in a significant tax savings. Consequently, the potential of recapture should be considered as a factor in any transaction involving partnership interests or property, even though there may be uncertainty as to the effect of certain transactions on investment credit.

Jim R. Titus '79*

\textsuperscript{134} Long v. United States, 79-2 U.S.T.C. (CCH) § 9612 (W. D. Tenn. 1979). The court stated: 
As far as we can ascertain, however, this distinction does not bear any relationship to the purpose of the recapture provision. The purpose of the recapture provision is to prevent a quick turnover of assets in an effort by a taxpayer to obtain multiple tax credits. There is clearly not any threat of multiple tax credits in this case.

\textit{Id.}


\textsuperscript{136} Id.

* Mr. Titus contributed this comment as a student project in 1979.