Soares v. Commissioner, 50 T. C. 909 (1968)

A change in business form resulting in a significant reduction of ownership interest requires recapture of the investment credit under Section 47(a)(1).

Summary

James Soares, who transitioned his sole proprietorship into a partnership and then into a corporation, was required to recapture his previously claimed investment credit. The court ruled that Soares's 7. 22% interest in the corporation was not 'substantial' under Section 47(b), as it did not meet the regulatory requirement of maintaining a substantial interest relative to all shareholders or equal to his prior interest. Consequently, his disposition of Section 38 property triggered the recapture of the investment credit, and the court upheld the negligence penalty under Section 6653(a).

Facts

James Soares operated a cement-hauling business as a sole proprietor, claiming investment credits in 1962 and 1963. On January 1, 1964, he formed a partnership, Sacramento Cement Transport, contributing his business assets for a 48% interest. On July 1, 1964, Soares exchanged his partnership interest for a 7. 22% interest in Sierra Distributing, Ltd. , an electing small business corporation, which then dissolved the partnership and absorbed its assets.

Procedural History

The Commissioner determined deficiencies in Soares's 1964 and 1965 tax returns, asserting that the exchange of his partnership interest for a smaller corporate interest constituted a disposition of Section 38 property, triggering investment credit recapture. Soares petitioned the United States Tax Court, which upheld the Commissioner's determination and the negligence penalty.

Issue(s)

1. Whether Soares disposed of Section 38 property in 1964, triggering the recapture of the investment credit under Section 47(a)(1)?
2. Whether the 5% addition to tax under Section 6653(a) applies due to negligence or intentional disregard of rules and regulations?

Holding

1. Yes, because Soares's 7. 22% interest in Sierra was not 'substantial' under Section 47(b), as it did not meet the regulatory criteria for maintaining a substantial interest.
2. Yes, because Soares failed to report certain income and relied on his accountant without absolving his responsibility, justifying the negligence penalty.

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Court’s Reasoning

The court applied Section 47(a)(1) and the regulations under Section 47(b), which provide an exception to recapture if the taxpayer retains a ‘substantial interest’ in the business after a change in form. The court interpreted ‘substantial interest’ under the regulations as requiring either a substantial portion of all outstanding shares or an interest equal to or greater than the prior interest. Soares’s interest decreased from 48% to 7. 22%, which did not meet either criterion. The court rejected Soares’s argument that the value of his interest should be considered, emphasizing that the regulations focus on percentage ownership. On the negligence penalty, the court upheld the Commissioner’s determination, stating that reliance on an accountant does not relieve a taxpayer of responsibility for accurate returns.

Practical Implications

This decision clarifies that when changing a business’s legal form, taxpayers must maintain a substantial interest to avoid investment credit recapture. Practitioners should advise clients to carefully consider the impact of ownership changes on previously claimed tax credits. The ruling underscores the importance of accurate tax reporting and the limited defense of relying on professional advice against negligence penalties. Subsequent cases have applied this precedent to similar situations involving changes in business structure and tax credit recapture.

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