Bremer v. Commissioner, 66 T. C. 360 (1976)

A foreclosure sale of section 38 property by a subchapter S corporation triggers investment credit recapture for its shareholders.

Summary

In Bremer v. Commissioner, shareholders of Savannah Inn & Country Club, Inc. , a subchapter S corporation, claimed investment credits for property placed in service in 1967. The corporation faced financial difficulties, leading to a foreclosure sale of its assets in 1970. The issue before the court was whether this foreclosure constituted a disposition under section 47(a)(1), triggering recapture of the investment credits. The court held that it did, reasoning that the recapture rule adjusts for discrepancies between estimated and actual useful life of the property, and the foreclosure sale was a disposition within the meaning of the statute. This decision underscores the broad application of the recapture rule and its implications for shareholders of subchapter S corporations.

Facts

Savannah Inn & Country Club, Inc. , a subchapter S corporation, was organized in 1965 to restore and operate the General Oglethorpe Hotel in Savannah. In 1967, the corporation placed certain assets in service, claiming an investment credit of $67,816. 67. The shareholders, including the petitioners, claimed their pro rata shares of this credit. By 1970, the corporation faced financial difficulties and could not meet its obligations. On February 3, 1970, the first mortgagee foreclosed on the property, selling all assets at auction, including those for which the investment credit had been claimed. The corporation ceased operations after the foreclosure.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' 1970 federal income taxes, asserting that the foreclosure sale triggered recapture of the investment credits claimed in 1967. The petitioners contested this determination, leading to the case being heard before the United States Tax Court.

Issue(s)

1. Whether the foreclosure sale of the assets of Savannah Inn & Country Club, Inc. , constitutes a disposition under section 47(a)(1) of the Internal Revenue Code, triggering recapture of the investment credits claimed by the shareholders.

Holding

1. Yes, because the foreclosure sale is considered a disposition under section 47(a)(1), and thus the shareholders are liable for the investment credit recapture tax.

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Court’s Reasoning

The court interpreted section 47(a)(1) as requiring recapture when section 38 property ceases to be such with respect to the taxpayer before the end of its useful life. The court emphasized that the regulation specifically includes a transfer upon foreclosure as a disposition. It rejected the petitioners’ argument that the recapture rule should not apply to involuntary transactions or those without financial gain, citing the broad application intended by Congress. The court also distinguished the case from the now-repealed section 47(a)(4), which provided an exception for property destroyed by casualty. The court’s decision was supported by prior cases such as *Henry C. Mueller*, which applied the recapture rule to transfers in bankruptcy.

Practical Implications

This decision has significant implications for shareholders of subchapter S corporations claiming investment credits. It clarifies that foreclosure sales, even if involuntary, trigger recapture, emphasizing the need for accurate estimation of property’s useful life. Legal practitioners advising such corporations must consider the potential for recapture in financial planning and ensure that clients understand the tax consequences of foreclosure. The decision also impacts how similar cases involving involuntary dispositions are analyzed, reinforcing the broad scope of the recapture provisions. Subsequent cases, such as *Gavin S. Millar* and *Emory A. Rittenhouse*, have followed this ruling, further solidifying its influence on tax law regarding investment credit recapture.

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