Fegan v. Commissioner, 71 T. C. 791 (1979)

The IRS may allocate income between related parties under IRC Section 482 to reflect arm's-length transactions, even when one party is an individual.

Summary

Thomas B. Fegan constructed a motel and leased it to Fegan Enterprises, Inc. , a corporation he controlled, at below-market rates. The IRS invoked IRC Section 482 to allocate additional rental income to Fegan, arguing the lease did not reflect an arm's-length transaction. The Tax Court upheld the IRS's allocation, finding the lease terms were not comparable to what unrelated parties would have agreed upon. Additionally, the court ruled that Fegan was entitled to investment tax credits on the leased property, as the lease was considered effective before a statutory change that would have disallowed such credits.

Facts

Thomas B. Fegan built a motel in Junction City, Kansas, and leased it to Fegan Enterprises, Inc. , where he owned 76% of the stock. The lease, executed in December 1971 but agreed upon earlier, provided a minimum annual rent of $45,600 plus a percentage of gross receipts over certain thresholds. Fegan reported minimal rental income from the motel but claimed depreciation and investment tax credits on the property. The IRS challenged the reported rental income and disallowed the investment credits.

Procedural History

The IRS issued a notice of deficiency to Fegan for the tax years 1970-1973, allocating additional rental income under IRC Section 482 and disallowing investment tax credits. Fegan petitioned the U. S. Tax Court, which upheld the IRS's allocation of income but allowed the investment tax credits, finding the lease was effectively entered before a statutory change that would have disallowed such credits.

Issue(s)

1. Whether the IRS properly allocated additional rental income to Fegan under IRC Section 482 for the years 1971-1973.
2. Whether Fegan was entitled to investment tax credits for the years 1971-1973 on property leased to Fegan Enterprises, Inc.

Holding

1. Yes, because the lease between Fegan and Fegan Enterprises did not reflect an arm's-length transaction, allowing the IRS to allocate additional income to Fegan to reflect a fair market rental.

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2. Yes, because the lease was considered effective before September 22, 1971, the date after which a statutory change would have disallowed investment tax credits to noncorporate lessors.

Court’s Reasoning

The court applied IRC Section 482, which allows the IRS to allocate income between related parties to prevent tax evasion or clearly reflect income. It found that Fegan’s lease to Fegan Enterprises did not meet the arm’s-length standard, as the rental was set to cover Fegan’s mortgage payments rather than reflecting fair market value. The court used a formula from the Treasury Regulations to determine a fair rental value, which was higher than what Fegan reported. Regarding the investment tax credits, the court determined that the lease was effectively entered before a statutory change that would have disallowed such credits to noncorporate lessors like Fegan. The court cited the Senate Finance Committee report, which clarified that oral leases effective before the change date were grandfathered.

Practical Implications

This decision reinforces the IRS’s authority to adjust income allocations between related parties under IRC Section 482, even when one party is an individual. It emphasizes the importance of ensuring that transactions between related parties are conducted at arm’s length to avoid IRS adjustments. For tax practitioners, this case highlights the need to carefully document and justify the terms of related-party transactions. The ruling on investment tax credits underscores the significance of the timing of lease agreements in relation to statutory changes, particularly for noncorporate lessors. Subsequent cases have cited Fegan in discussions of Section 482 allocations and the treatment of investment tax credits for leased property.

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