Bonaire Development Co. v. Commissioner, 76 T. C. 789 (1981)

Prepaid management fees are not deductible if they create an asset extending beyond the taxable year, and depreciation recapture applies even in corporate liquidations with step-up in basis.

Summary

In Bonaire Development Co. v. Commissioner, the Tax Court addressed whether a cash basis corporation, & V Realty Corp. , could deduct prepaid management fees and whether depreciation recapture applied upon its liquidation. & V paid management fees for the entire year in advance, but was liquidated before the year's end. The court held that the fees were not deductible as ordinary and necessary expenses because they created an asset extending beyond the taxable year. Additionally, the court ruled that depreciation recapture under section 1250 applied to the liquidating corporation despite the transferee's step-up in basis under section 334(b)(2).

Facts

N & V Realty Corp. , a cash basis taxpayer, owned a shopping center and entered into a management contract with Lazarus Realty Co. for $24,000 annually, payable at $2,000 monthly. & V prepaid the full $24,000 within the first five months of 1964. Branjon, Inc. , purchased & V's stock in May 1964, and & V was liquidated on May 19, 1964, distributing its assets, including the shopping center, to Branjon. & V claimed a deduction for the full $24,000 on its 1964 tax return. Branjon sold the shopping center in August 1964.

Procedural History

The IRS disallowed $14,000 of the $24,000 management fee deduction and assessed a deficiency. Bonaire Development Co. , as successor to Branjon, Inc. , contested the deficiency in the U. S. Tax Court. The court upheld the IRS's determinations.

Issue(s)

1. Whether a cash basis corporation can deduct prepaid management fees for services to be rendered after its liquidation?
2. Whether depreciation recapture under section 1250 applies to a liquidating corporation when the transferee gets a step-up in basis under section 334(b)(2)?

Holding

1. No, because the prepaid fees created an asset with a useful life extending beyond the taxable year, and were not ordinary and necessary expenses at the time of payment.
2. Yes, because section 1250 recapture applies notwithstanding the nonrecognition

© 2025 SCOTUSreports.com. All rights reserved.

provisions of section 336 and the step-up in basis under section 334(b)(2).

Court’s Reasoning

The court reasoned that the prepaid management fees were not deductible as they constituted a voluntary prepayment creating an asset that extended beyond & V’s taxable year, which ended with its liquidation. The court cited *Williamson v. Commissioner* to support that such voluntary prepayments are not ordinary and necessary expenses. Additionally, the court applied the tax benefit rule, reasoning that & V must include in income the fair market value of the services not used before liquidation. On the depreciation recapture issue, the court found that section 1250 applies even in liquidations where the transferee gets a step-up in basis under section 334(b)(2), as the transferee’s basis is not determined by reference to the transferor’s basis. The court rejected Bonaire’s collateral estoppel argument regarding the useful life of the shopping center due to insufficient evidence linking the property in question to a prior case.

Practical Implications

This decision clarifies that prepaid expenses for services extending beyond a corporation’s taxable year, especially in cases of liquidation, are not deductible as ordinary and necessary expenses. It emphasizes the importance of aligning expense deductions with the period of benefit. For practitioners, this means advising clients to carefully structure and document prepayments and consider the implications of liquidation on tax deductions. The ruling also confirms that depreciation recapture under section 1250 applies in corporate liquidations, impacting how such transactions are planned to avoid unexpected tax liabilities. Subsequent cases have referenced Bonaire in addressing similar issues of prepayments and recapture in corporate dissolutions.

© 2025 SCOTUSreports.com. All rights reserved.