

Section 47.-Certain Dispositions, Etc., Section 38 Property
26 CFR 1.47-2: Disposition and cessation. (Also Sections 38, 48;
1.48-1.)

Investment credit; recapture; disqualified use of property.
When section 38 property is sold to a tax-exempt organization and,
as part of the same transaction, is leased back to the seller,
investment credit recapture is required unless the property is
used predominantly in an unrelated trade or business, the income
from which is subject to tax under section 511 of the Code.

ISSUE

If section 38 property is sold to a tax-exempt organization
and, as part of the same transaction, is leased back to the
seller, does the sale and leaseback exception in section 1.47-3(g)
of the Income Tax Regulations to the investment credit recapture
rules in section 47 of the Internal Revenue Code preclude
recapture?

FACTS

On January 1, 1984, X, a calendar year corporation, placed in
service new section 38 property. The section 38 property was
5-year recovery property as defined in section 168(c)(2)(B) of the
Code. X properly claimed the investment credit with respect to
the section 38 property.

In 1985, X sold the section 38 property to Y, a tax-exempt
organization and leased it back. The leasing of the property by Y
to X is not subject to tax under section 511 of the Code as part
of an unrelated trade or business. The lease agreement is a valid
lease for federal income tax purposes.

LAW AND ANALYSIS

Section 38 of the Code allows as a credit against federal
income tax a general business credit that includes the investment
credit for qualified investment in section 38 property. Section
49, as added by the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B.
___, effectively eliminates the regular investment credit for
property placed in service after December 31, 1985, with certain
exceptions.

Section 47(a)(5)(A) of the Code provides that, in general, if
in any taxable year before the close of the recapture period,
section 38 recovery property is disposed of or otherwise ceases to
be section 38 property as to a taxpayer, then the tax for that
year is generally increased by the recapture percentage (as
provided by the recapture percentage table under section
47(a)(5)(B) of the Code) of section 38 credit previously claimed
by the taxpayer with respect to the property.

Section 47(a)(5)(E)(i) of the Code defines the term section 38 recovery property to mean any section 38 property that is recovery property (within the meaning of section 168).

Section 47(a)(5)(E)(ii) of the Code defines the term recapture period to mean, with respect to any recovery property, the period consisting of the first full year after the property is placed in service and the four succeeding full years in the case of 5-year property.

Section 1.47-2(a)(1) of the regulations states that for recapture purposes, the term 'disposition' includes a sale in a sale and leaseback transaction. However, section 1.47-3(g) of the regulations provides that recapture does not occur where section 38 property is disposed of and as part of the same transaction is leased back to the vendor even though gain or loss is recognized to the vendor-lessee and the property ceases to be subject to depreciation in its hands.

Section 48(a)(4) of the Code states that property used by an organization exempt from the tax imposed by chapter 1 shall be treated as section 38 property only if such property is used predominantly in an unrelated trade or business the income of which is subject to tax under section 511. Section 1.48-1(j) of the regulations provides that property used by a tax-exempt organization includes property owned by the organization (whether or not leased to another person).

Section 1.47-3(g) of the regulations precludes investment credit recapture that would otherwise be triggered when section 38 property is sold and leased back to the vendor. The sale and leaseback exception is intended to prevent recapture when the section 38 property for which the credit was claimed continued to be used by the taxpayer even though legal title was transferred to another person. But for section 1.47-3(g), the sale and leaseback would be a disposition that triggers recapture. See section 1.47-2(a)(1) of the regulations. Section 1.47-3(g), however, bars only that recapture which otherwise would flow as a direct consequence of the sale and leaseback transaction itself. The provision does not preclude recapture that results from other causes, for instance, a disqualifying use of the property.

In such a situation, recapture would be required even if, as a factual matter, the sale leaseback transaction was an essential step in bringing about the disqualifying use.

In the present situation, the property became owned by a tax-exempt organization that did not use the property in an unrelated trade or business. Hence the property ceased to be section 38 property and section 1.47-3(g) of the regulations, which is limited in its applicability to the sale and leaseback of section 38 property, does not prevent recapture. Recapture of investment credit in this situation is triggered by the disqualifying use by

the tax- exempt organization rather than by the sale and leaseback. See Rev. Rul. 73-76, 1973-1 C.B. 31, which holds that a corporation that changed its status to an exempt organization must recapture investment credit on property that had a remaining useful life when the status change occurred.

An interpretation of section 1.47-3(g) of the regulations to reach a contrary result would be inappropriate. If an exempt organization purchases property and leases it to a nonexempt entity (and the lease does not constitute an unrelated trade or business), neither the exempt organization nor the nonexempt entity is permitted the investment credit because, under section 48(a)(4) of the Code, the property is not section 38 property. If the property is instead purchased by the non-exempt entity, which then enters into a sale and leaseback with the exempt organization, the parties are left in the same economic position as if the exempt organization had purchased the property in the first instance. If the investment credit is disallowed in the first case but is not recaptured in the second, similarly situated taxpayers would be treated differently.

HOLDING

When section 38 property is sold to a tax-exempt organization and leased back, the seller/lessee is subject to investment credit recapture unless the property is used by the purchaser/lessor predominantly in an unrelated trade or business the income from which is subject to tax under section 511 of the Code.