INVESTMENT CREDIT RECAPTURE MAY BE TRIGGERED BY SOME SURPRISING TRANSACTIONS

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Taxpayers are often surprised to learn that an investment credit that they have worked so hard to earn must be "recaptured." The concept of recapture is simple: a taxpayer must add to its tax liability all or part of a previously claimed credit if the property or asset that generated the credit is no longer used by the taxpayer in a qualifying manner. Recapture can occur after such seemingly innocuous transactions as a sale/leaseback or an IRC Section 338(h)(10) election. Though incidents of credit recapture are not widespread, taxpayers may unknowingly trigger a recapture event resulting in the loss of a previously earned credit.

While many states defer to the federal recapture provisions of IRC Section 50,[1] some states have statutes and regulations setting forth their own credit recapture rules. Thus, it is useful to examine the federal investment tax credit recapture structure along with some recent state case law and administrative rulings from various jurisdictions. Although the decisions discussed herein concern investment credit recapture, they nonetheless provide a good reference point for examining the recapture issue as it relates to other types of tax credits as well.

Federal Investment Tax Credit

In general, the federal investment tax credit was enacted to serve as an incentive device to stimulate the purchase or modernization of certain kinds of productive assets by permitting a reduction in tax liability based on the taxpayer's qualified investment in certain kinds of property placed in service during the tax year. Thus, the taxpayer can reduce its federal income tax liability by a percentage of the cost of the assets.[2]

Credit structure has changed. Originally, the federal investment tax credit applied to almost all new tangible personal property used in a trade or business. By contrast, the current investment credit is relatively limited. In the Revenue Reconciliation Act of 1990 (RRA '90), Congress entirely rewrote the investment credit provisions to reflect the 1986 repeal of the regular investment credit.[3] The current investment credit consists of the

[1] Pre-Revenue Reconciliation Act of 1990 (RRA '90) IRC § 47(a)(5) and current IRC § 50(a) provide rules for recapturing the investment credit when the property on which the credit was claimed is disposed of or ceases to be investment credit property.

[2] The federal investment credit becomes a component of the general business credit and is applied, along with any other credits the taxpayer may have, against tax for the year in which the property generating the credit is placed in service, subject to various limitations on the amount of tax that may be offset. IRC § 38.

[3] The Tax Reform Act of 1986 (TRA '86) repealed the investment credit to finance the substantial reduction in tax rates enacted in TRA '86 and to eliminate the economic distortion caused by the existence of the regular investment tax credit.

rehabilitation credit, the energy credit, and the reforestation credit.[4] Certain rules of the former investment tax credit, however, were carried over to the present investment credit. For example, the recapture provisions, among other things, were carried over and rearranged from former IRC Section 47 to the current IRC Section 50(a)(1).

As with the rules for claiming the investment tax credit, some federal law regarding credit recapture has changed. The IRC requires recapture of a credit only if the property "is disposed of, or otherwise ceases to be investment property with respect to the taxpayer."[5] In general, property is deemed disposed of when it is sold, exchanged, transferred, distributed, involuntarily converted, or transferred by gift.[6] A sale coupled with a leaseback is a disposition (unless the two occur simultaneously as part of the same transaction), as is a transfer on foreclosure of a security interest. A transfer of property merely as security, however, is not a disposition.[7] To remain eligible for the credit, the property must continue in the hands of the lessor, the lessee, and any sublessee. If any of these parties becomes ineligible to hold IRC Section 38 property,[8] or if the taxpayer's use of the property makes it ineligible as Section 38 property, the credit must be recomputed.[9]

The portion of the credit recaptured depends on how long the property was in service. The taxpayer is allowed 20% of the credit for each full year in which recovery property[10] is actually in service. Thus, if the property ceases to qualify for the credit after the three full years of service, 60% of the credit has been earned and 40% is to be recaptured. As a result, after five full years from the date the property is placed in service, no portion of the credit is subject to recapture. Under prior law, the recapture amount for an investment credit claimed on depreciable recovery property depended on the property's useful life.[11] For example, if an asset with a three-year useful life was disposed of or otherwise ceased to be IRC Section 38 property during the first year after it was placed in service, 100% of the credit was recaptured. Recapture during the second and third years was, respectively, 66% and 33%. If the basis of the property was reduced by the original credit claimed, that basis is increased by the recapture amount.[12]

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[4] The investment credit provisions are set out in IRC § § 46 through 50.

[5] IRC § 50(a)(1). Similar language was contained in pre-RRA '90 IRC § 47(a)(1).

[6] See Treas. Reg. 1.47-1(c); S. Rep't No. 1881, 87th Cong. 2d Sess. 1-48-149 (1962); Lang v. C.I.R., TCM 1972-8. See also Ltr. Rul. 8948019 (the grant of an option to purchase energy-generating equipment did not trigger investment tax credit recapture for the owners of the equipment because generating an option is not a disposition).

[7] Millar v. C.I.R., TCM 1975-113, *vac'd and rem'd* 540 F.2d 184, 38 AFTR2d 76-5628 (CA-3, 1976); Treas. Regs. 1.47-2(a)(1) and (2).

[8] IRC § 38 property generally refers to property eligible for the credit. The term had been defined by statute in pre-RRA '90 IRC § 48.

[9] Treas. Regs. 1.47-2(b)(1) and (2)(v).

[10] Recovery property is property the taxpayer depreciates under the modified accelerated cost recovery system (MACRS) of IRC § 168.

[11] If nonrecovery property (e.g. property for which the taxpayer had elected under IRC § 168(f)(1) not to depreciate under MACRS) was disposed of before the end of the useful life originally used in determining the qualified investment, the credit had to be recomputed by substituting the actual period of use for the original useful life, thereby reducing the qualified investment. IRC § 50(a) and pre-RRA '90 IRC § 47(a)(1).

[12] IRC § 50(c)(2).

State Investment Tax Credit

In general, state investment tax credits are granted pursuant to statutory provisions and are available regardless of a taxpayer's state of incorporation or commercial domicile. These tax credits typically are not negotiable, because the credit generally is computed under a fixed statutory formula based on a taxpayer's qualifying investment. The greater the investment in qualifying assets, the greater the credit will be. Nonetheless, some credits may be negotiated with state and local government officials, resulting in customized credits and incentives.

Many states have enacted tax credits to encourage taxpayers to invest in capital assets in the state.[13] Much like the federal credit, the main purpose of the state credit is to stimulate capital investment in specific types of assets, such as machinery and equipment held for investment or use in the taxpayer's business. State investment tax credits usually are calculated by multiplying the qualifying investment by a statutory percentage.[14] In many instances, the calculation of the credit is based on an increase in the taxpayer's qualified investment or employment over a base year.[15] Qualifying investments generally cover equipment and facilities used in manufacturing, mining, retailing, and technology-related industries. Investment credit statutes often provide a laundry list of investments that qualify. In addition, the rules frequently require that jobs not be lost during the tax year in which the investment is made. The investment credit may be based on the number of new jobs that can be directly attributed to the investment.[16]

State recapture does not necessarily follow federal practice. Recapture provisions also are an integral part of state investment credit rules, with many states deferring to IRC Section 50.[17] Many states investment credits feature "clawback" provisions that require a taxpayer to recapture or reimburse the government for benefits it previously received if certain conditions are not satisfied.[18]

New York, for example, provides for recapture if investment credit property is disposed of or ceases to be in qualified use prior to the end of its useful life. Furthermore, a formula for computing the recapture is set forth in regulations.[19] A

[13] See e.g. California, Colorado, Connecticut, Illinois, Massachusetts, New York, Ohio, Oklahoma, Rhode Island, Texas, and West Virginia, to name just a few.

[14] Under California's manufacturers' investment credit, for example, a 6% credit is allowed on the qualified costs of qualified equipment placed in service in the state. Cal. Rev. & Tax. Code § 23624. See generally Danowitz, Leombruno, and Farrell, "California Manufacturers' Investment Credit Regs. Seem to Narrow the Statute's Scope," 6 JMT 82 (May/Jun 1996).

[15] Illinois, for example allows an additional credit of 0.5% of the basis of qualified property when the taxpayer's employment in Illinois increases by at least 1%. 35 ILCS 5/201(e)(2).

[16] Id.

[17] See e.g. Alaska Admin. Code. tit. 15, § 20.110(e); Colo. Code Regs. § 39-22-507-5(a); Idaho Reg. Rule 35.01.01.715; and Mont. Code Ann. § 15-30-162(5).

[18] See e.g. Cal. Rev. & Tax Code § 23649(g); 35 ILCS 5/201(e)(7); Mass. Gen. Laws. ch. 63, §31A(e); N.Y. Tax Law § 210.12(g); R.I. Gen. Laws § 44-31-1; and W.Va. Code § 11-13C-8a.

[19] Under 20 N.Y. Comp. Codes, Rules & Regs. § 5-2.8(b), the investment tax credit that must be added back is computed as follows: (1) the original credit claimed is multiplied by the ratio of (a) the total months the property was in qualified use, to (b) the total months of useful life; (2) that recomputed credit allowed for actual use is subtracted from the original credit claimed; (3) the difference is added back to the tax due for the year in which the property was disposed of or ceased to qualify.

disposition of qualified property occurs when the property is sold; traded in; given away; transferred on foreclosure of a security interest in the property; retired before the end of its useful life; condemned; lost due to fire, theft, storm, or other casualty; or transferred to a corporation that is not taxable under Article 9-A (New York's franchise tax).[20] Property is deemed disposed also when the taxpayer is liquidated other than as part of a statutory merger or consolidation; no disposition occurs when property is transferred as part of a transaction to which IRC Section 381(a) applies.[21]

In Illinois, recapture provisions apply if, within 48 months after being placed in service, (1) any property for which the credit was taken ceases to be qualified property in the hands of the taxpayer or (2) the situs of any qualified property is moved outside Illinois.[22] Illinois regulations provide an extensive list of transactions that require recapture of a credit, including when the property is sold; traded in exchange for the new property; abandoned or retired from use; destroyed by casualty; stolen; transferred by gift; transferred to a trustee in a bankruptcy proceeding; or foreclosed.[23]

In short, state recapture provisions generally take effect when the taxpayer that claimed the credit no longer complies with the statutory prerequisites for the credit. As a result, it is paramount for taxpayers to ensure that they continue to use the credit-generating asset in a qualifying manner and that they maintain the level of investment, employment, or other commitment required under the applicable credit provisions.

Whether a credit previously earned must be recaptured usually is a matter of statutory construction. Statutes may be interpreted in more than one way, of course, thereby resulting in conflict between taxpayers and state revenue departments. To the extent that each side is firm in its position, litigation is inevitable. The following examples of recent case law and administrative rulings illustrate the types of recapture issues that may arise in situations such as IRC Section 338 transactions, tax-free mergers, spin-offs relating to corporate partnerships, temporary cessation of operations, and sale/leasebacks. These examples underscore the notion that state investment credits may be lost just as easily as they are earned.

Section 338 Transactions

In an advisory opinion, the New York State Department of Taxation and Finance ruled that a sale of a subsidiary in an IRC Section 338(a) transaction represented a disposition of assets requiring a recapture of the "old" target corporation's previously earned investment tax credit.[24] The taxpayer intended to sell shares of a wholly owned subsidiary to an unrelated third party. Both the taxpayer and the buyer intended to make an IRC Section 338(a) election whereby the sale of the shares would be deemed a sale by the subsidiary ("old" target) of its assets on the stock acquisition date and a purchase by the subsidiary ("new" target) of those assets as of the beginning of the next day. In addition, the taxpayer's consolidated group intended to elect under IRC Section 338(h)(10) to recognize gain or loss on the deemed sale of the subsidiary's assets. The target corporation had previously claimed an investment tax credit for qualifying assets purchased and placed in service in New York.

As noted above, New York's statutes and regulations provide that if property on which investment tax credits have been claimed is disposed of or ceases to be in qualified use prior to

20 20 N.Y. Comp. Codes, Rules & Regs. § 5-2.8(c).

21 *Id.* § 5-2.8(c)(2) and (e).

22 35 ILCS 5/201(e).

23 Ill. Admin. Code. tit. 86, § 110.2101(g)(2).

24 N.Y.S. Dept. of Tax'n and Finance, Advis. Op., TSB-A 98(20)C, 11/3/98.

the end of its useful life, the difference between the credit taken and the recomputed credit allowed for actual use must be added back to the tax otherwise due for the year of disposition or disqualification. In the advisory opinion, the Department of Taxation determined that when an IRC Section 338(a) election is made, the assets of the "old" target corporation are deemed sold at the close of the acquisition date at fair market value in a single transaction. Accordingly, the "old" target corporation is required to recapture the statutorily determined amount of any previously claimed investment tax credits. The Department further ruled, however, that the "new" target corporation, which is deemed to acquire the "old" target corporation's assets pursuant to the IRC Section 338 election, may claim the investment tax credit if the property in question continues to be used in a qualifying manner.

Tax-Free Mergers

In another advisory opinion, *EnviroGro Technologies, Inc.*,[25] the New York State Department of Taxation and Finance held that there was no disposition of qualified property in a tax free merger involving the two corporate partners of a partnership that owned qualified property. Accordingly, no recapture of previously earned credits was required.

Here, the partners (holding, respectively, 51% and 49% partnership interests) were wholly owned subsidiaries of another corporation. The partnership acquired investment credit property and each partner claimed its share of the partnership's credit. Subsequently, one of the partners formed its owned wholly owned subsidiary to which it transferred a 1% partnership interest. Then, the first two partners were merged into their parent corporation. Thus, the parent now held a 99% partnership interest, and also wholly owned the newly formed subsidiary that held the other 1% interest.

According to the Department, the transfer of the partnership interest on the formation of the new subsidiary and the subsequent mergers all were tax-free transactions for both federal and New York tax purposes, and were not "dispositions" of investment credit property for purposes of the state's recapture rules. Thus, as long as the property continued in qualified use for its entire life or for more than 12 consecutive years, the investment credits claimed by the subsidiaries would not be recaptured despite the corporate reorganizations. While this ruling is taxpayer friendly, it raises the possibility that under another state's interpretation of its own laws, a tax-free merger or exchange may be a "disposition" for investment credit purposes, thereby requiring recapture of any previously claimed credit.

Corporate Spin-Offs Relating to Partnerships, LLCs

In a similar ruling, the New York State Department of Taxation and Finance said that recapture of the investment tax credit on equipment was not required when the taxpayer – the corporation that purchased the equipment and earned the credit – transferred the equipment to its newly formed, 90% owned limited liability company (LLC) in a tax-free exchange.[26] In the advisory opinion, the corporate taxpayer was a New York film production company that formed a new videotape post-production division, purchasing $1 million worth of state-of-the-art equipment that qualified for the investment tax credit. The following year, the corporation spun-off the division to the LLC, resulting in the transfer of the equipment to the LLC.

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[25] N.Y.S. Dept of Tax'n and Finance, Advis. Op. TSB-A-97(9)C, 3/28/97.

[26] N.Y.S. Dept. of Tax'n and Finance, Advis. Op., TSB-A-96(12)C, 5/2/96.

According to the Department, New York, consistent with federal tax law, treats as a partnership an LLC that is deemed a partnership for federal income tax purposes. Similarly a corporate member of the LLC is treated like a partner of a partnership. The Department then noted that, just as with a partner in a partnership, a corporate member of an LLC may claim its share of any investment tax credits for qualifying property used by the LLC. In addition, the Department said, the spin-off of the division to the LLC was merely a change in the form of conducting the business, and was not a disposition of the investment credit property. Thus, the Department said, as long as the property continued to be in qualified use by the LLC, it also continues to be in qualified use by the corporate member, and no credit recapture was required. Again, however, while this result is taxpayer friendly, the outcome could be different with the same set of facts under the laws of another state.

Temporary Break in Use of Property

In *Matter of Parsons & Whittemore, Inc.,*[27] the New York State Tax Appeals Tribunal ruled that the taxpayer was not required to recapture its investment tax credit even though the qualifying property temporarily ceased to be used prior to the end of the tax year in which the credit was taken. The taxpayer filed a combined franchise tax report with its wholly owned subsidiary that operated a solid waste disposal and recycling plant, where the waste was converted into electricity. An investment credit was claimed on various equipment placed in service in the plant. Subsequently, however, questions were raised as to whether the plant would be in compliance with federal Environmental Protection Agency standards, and the local town forced the taxpayer to close the plant. This shutdown was to be temporary since the taxpayer intended to comply with any federal environmental requirements and then reopen the plant. The taxpayer never did reopen the plant, however, and sold it a few years later. The plant did reopen after the new owner modified the facility to comply with federal environmental standards.

The Division of Taxation argued that the taxpayer had to recapture the investment credit claimed because, under New York's statutes and regulations, the property had ceased to be used for qualified purposes.[28] The Division disputed the temporary nature of the shutdown, arguing that the duration must be determined based on knowledge of subsequent events. At the initial hearing, however, an administrative law judge (ALJ) found otherwise.

On appeal, the Tax Appeals Tribunal affirmed the ALJ's finding, although it rejected her reliance on the federal "placed in service" rules to determine whether the property was still in qualified use.[29] Instead, the Tribunal stated that the proper standard for determining whether investment credit property was in qualified use is the taxpayer's intent at the time it ceases using the property. Thus, to avoid recapture, it was sufficient to show that, at the close of the tax period at issue, the taxpayer intended to temporarily shutdown the facility as a result of circumstances beyond its control. Accordingly, in *Parsons & Whittemore,* because the taxpayer intended throughout the tax year to reopen the facility, the property did not cease to be in qualified use and, therefore, the taxpayer was not required to

[27] N.Y.S. Tax App. Trib., DTA No. 802196, 10/3/91.

[28] N.Y. Tax Law § 210.12(g); 20 N.Y. Comp. Codes, Rules & Regs.§ 5-2.8(d)(1).

[29] To determine when qualified property is "placed in service," and thus eligible for the investment credits, Treas. Reg. 1.46-3(d) looks to the earlier of the tax year in which (1) under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; or (2) the property is placed in a condition or state of readiness and availability for a specifically assigned function.

recapture the investment credit.

Finally, the Tribunal noted that if the state's position were followed (i.e., use subsequent events to determine whether qualified use had ceased, thus requiring credit recapture), the possibilities of administrative headaches for taxpayers could be endless. The taxpayer would have to decide at the close of the tax period – with no opportunity for hindsight – whether a temporary shutdown would eventually turn into a permanent cessation of operations. Furthermore, the Tribunal said, to require recapture for a temporary stoppage of a taxpayer's operations would undermine a stated purpose of New York's investment credit scheme – simplification. For example, a taxpayer would need to maintain bookkeeping entries documenting all periods of activity and temporary inactivity for every production asset. In addition, once the property was returned to operation, it would be necessary to determine the taxpayer's ability or inability to reclaim the credit. Certainly, the thought of such administrative difficulties motivated the Tax Appeals Tribunal to conclude that taxpayer intent is the standard for determining whether a halt in operations was not merely temporary and thus required credit recapture.

Sales/Leaseback

At first glance, one might presume that recapture of an investment tax credit is not required if the qualified property never leaves the taxpayer's hands. In *May Department Stores Company v. Illinois Department of Revenue*,[30] however, the Illinois Appellate Court held that a sale/leaseback transaction triggered recapture of the taxpayer's Illinois investment tax and enterprise zone credits for qualified property under the state's Income Tax Act. This case is especially significant because the taxpayer, under the circumstances described below, was not required to recapture investment credit for federal income tax purposes.[31]

Despite the court's conclusion, a sale/leaseback transaction is not necessarily fatal to a previously claimed investment credit. Under the proper circumstances, a seller/lessee in a sale/leaseback transaction can retain sufficient indicia of ownership to be deemed the owner for investment credit or other tax purposes.[32] This would be the result if, for example, the lease in question were a "financing transaction" rather than a "true" lease.[33] In *May Department Stores*, however, the taxpayer was unable to demonstrate that the lease was a financing device.

The facts. In 1990, Venture Stores, Inc., a wholly owned subsidiary of the taxpayer, May Department Stores Company, sold various real estate properties (a warehouse and 30 retail stores, including 18 in Illinois) to an unrelated insurance company and then leased the properties back from the purchaser. The taxpayer continued to use the 18 Illinois properties as retail stores in the same manner as before the transaction.

Prior to the sale, the taxpayer had claimed state and federal investment tax credits and state enterprise zone credits on qualified property in use at the 18 Illinois retail outlets. Under federal law, as noted above, the taxpayer was not required to recapture any credits for federal tax purposes as a

30 Ill. App. Ct. 1st Dist. Nos. 1-99-0793 and 1-99-1083, 5/10/00.

31 The financing transaction at issue was a sale/leaseback, which, under Treas. Reg. 1.47-3(g), is not a disposition for federal credit recapture purposes.

32 Cole Hospital, Inc. v. Champaign County Bd. of Review, 113 Ill App. 3d 96, 446 N.E.2d 562 (4th Dist., 1983) (seller/lessee qualified for property tax exemption when a sale and leaseback arrangement was used as a financing device).

33 See, e.g., Vincent, "Synthetic Leases: Differing Tax and Accounting Treatment May Offer Double Benefits," 9 JMT 20 (February 2000).

result of the sale/leaseback transaction. Nevertheless, the Illinois Department of Revenue determined that the taxpayer was required to recapture its previously claimed credits when the property was subject to the sale/leaseback because the transaction constituted a disposition of the property.[34] The taxpayer protested, and a hearing was held before an administrative law judge.

The initial proceedings. The ALJ ruled that in the absence of a specific statutory language excluding a sale/leaseback from a disqualifying "disposition," such a transaction required recapture of the investment credit.[35] The taxpayer had argued that the sale/leaseback was nothing more than a financing transaction where the seller retained sufficient indicia of ownership to be deemed the owner for tax purposes. The ALJ, for several reasons, found that the taxpayer failed to demonstrate that the sale/leaseback was merely a financing transaction or that the taxpayer's relationship to the property was any different from that of a lessee who had leased property from an unrelated party.

First, according to the ALJ, the taxpayer's payment of taxes, insurance, and utilities on the property, in addition to rent, was typical of a true, net lease. Second, for financial accounting purposes,[36] as well as for federal income tax purposes,[37] one indication that a sale/leaseback is merely a financing transaction is that the lessee has the use of the property for substantially all of the property's useful life. In this case, no evidence was introduced as to the property's useful life. Third, the lease contained no bargain purchase option provisions that would have virtually guaranteed that the taxpayer/lessee would purchase the property at the end of the lease.[38] Fourth, the mere fact that the taxpayer simultaneously leased the premises from the purchaser did not make this a financing transaction. The ALJ determined that the purchaser in the sale/leaseback held legal title to the property, and therefore ruled that the sale/leaseback was a disposition that triggered recapture of the investment credit.

The Circuit Court of Cook County affirmed the ALJ decision.[39] Even though the taxpayer did not have to recapture the investment credit at the federal level, the circuit court ruled that recapture was required for Illinois purposes. The court rejected the taxpayer's argument that the Illinois credit essentially was identical to the federal credit, and that in the absence of any statutory or regulatory reference to the effect of a sale/leaseback, the Department of Revenue must

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[34] The Illinois Income Tax Act requires that an asset be "acquired by purchase" in order to qualify for the state investment credit. 35 ILCS 5/201(e). The Department of Revenue determined on audit that the assets in question were no longer "acquired by purchase" after the taxpayer sold them and then *leased* them back.

[35] Illinois Dept. of Revenue v. The XYZ Co., ALJ Decision, IT 98-4, 11/30/98.

[36] Financial Accounting Standards Board (FASB) Statement No. 13, "Accounting for Leases," lists four criteria any one of which indicates that a lease is a "capital" lease, i.e., essentially a financial agreement that covers the purchase price of an asset and which requires that the property be reflected as an asset on the lessee's balance sheet, along with the related liability.

[37] See Rev. Proc. 75-21, 1975-1 CB 715, as modified by Rev. Proc. 76-30, 1976-2 CB 647. Federal case law regarding the weight to be given to the various indicia of ownership is not conclusive. See, e.g., Frank Lyon Co. v. U.S. 435 U.S. 561, 41 AFTR2d 78-1142 (1978) (sales/leaseback was a true sale); Sun Oil Co. v C.I.R., 562 F.2d 258, 40 AFTR2d 77-5737 (CA-3, 1977), *cert. den.* 436 U.S. 944 (1978) (sale/leaseback was a financing transaction).

[38] A bargain purchase option is another of the capital lease indicators in FASB No.13, *supra* note 36.

[39] May Department Stores Co. v. Ill. Dept. of Revenue, Ill. Cir. Ct., Cook County, No. 96 L 50934, 2/5/99.

follow the IRS regulation that expressly exempts sale/leaseback from recapture.[40] The circuit court noted, however, that the Illinois Income Tax Act contemplated a continual examination as to whether property remains qualified,[41] and that a sale/leaseback extinguished two statutory conditions for qualification, i.e., the property must be (1) depreciable (in the hands of the taxpayer) and (2) acquired by purchase. Also, the court noted the statutory requirement that qualifying property remain "in the hands of the taxpayer" for 48 months after being placed in service, and found that "in the hands of the taxpayer" meant continuing ownership by the taxpayer. Therefore, the circuit court concluded that a sale/leaseback resulted in credit recapture.

The appellate court's view. The Illinois Appellate Court, in an unpublished opinion, upheld the lower court's and administrative tribunal's determination that the taxpayer's sale/leaseback triggered a recapture of the investment credit. The appellate court, like the ALJ, based its opinion on the taxpayer's failure to show that the sale/leaseback transaction was a financing device. According to the court, the taxpayer neither offered any evidence regarding the intent behind the sale/leaseback nor indicated the purpose of the arrangement. Also, the taxpayer had argued that the lease was for the entire useful life of the property because the maximum term of the lease was 40 years,[42] and the Internal Revenue Code provides for a 39-year useful life for nonresidential real property. The appellate court, however, found that the taxpayer did not establish that the Code was the proper standard by which to measure the useful life of the property in question. Moreover, according to the appellate court, that the taxpayer had only a right of first offer to purchase if the lessor desired to sell, as opposed to an absolute right to purchase the property, did not help the taxpayer's cause.

Import of the case. In short, *May Department Stores* underscores the notion that an otherwise innocuous transaction, undertaken strictly for financing purposes, can result in investment credit recapture even when the taxpayer continues to use the credit-generating assets in its business. An investment credit, like any other credit, is a creature of statutory law. As evidenced by *May Department Stores*, a taxpayer risks losing a credit unless it continues to fully comply with all statutory and regulatory requirements.

Although in *May Department Stores*, the taxpayer was required to recapture its previously earned credit, the court's decision still leaves open the possibility that another Illinois taxpayer will not be subject to recapture after a sale/leaseback if the transaction in question is, in fact, a financing lease.

Conclusion

Though tax credit recapture cases are not widespread, they do occur. Whether the situation is a tax-free merger, spinoff, or sale/leaseback, the possibility of credit recapture is very real. Taxpayers and practitioners should familiarize themselves with the credit recapture provisions for any credit earned, since recapture does not necessarily apply only with regard to investment tax credits. A good starting point is determining

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[40] Note 31, *supra*.

[41] Both sections 201(e) ("Investment credit") and 201(f) ("Investment credit; Enterprise Zone") of the Illinois Income Tax Act provide that an investment credit taken in a prior year is recomputed if during the year "property ceases to be qualified property in the hand of the taxpayer within 48 months after being placed in service."

[42] The lease had an initial term of 20 years, with options to extend the lease for four five-year periods.

whether a state has its own credit recapture provisions or whether the state follows IRC Section 50. Significantly, a taxpayer that is not required to recapture a credit for federal purposes is not necessarily immune from recapture for state purposes.