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LOOKING A GIFT-HORSE IN THE MOUTH: SOME OBSERVATIONS AND SUGGESTIONS FOR IMPROVING INTERNAL REVENUE CODE SECTION 1244

by

Henry F. Johnson* & Mark W. Cochran**

MOST investors who contemplate a new business venture concentrate on the positive financial aspects of the business. Few investors realize that a thorough tax plan for a prospective business must also account for the contingency of failure. Since the failure of a business venture will, in some way, result in a taxable event, the conscientious corporate planner must devise a strategy that will utilize the losses incurred in order to achieve the most advantageous tax result. Internal Revenue Code section 1244¹ is not new, not particularly complex, and not fraught with misfortune for taxpayers failing to meet its provisions.² This section is, however, relatively unknown to many attorneys, even though not qualifying a new corporation's stock under section 1244 is tantamount to malpractice.³

In most cases, when a stockholder's investment in a corporation becomes worthless, the investor's loss will constitute a capital loss.⁴ In contrast, a partner or individual proprietor in a losing venture usually is entitled to deduct his loss as an ordinary loss.⁵ In 1958 Congress alleviated this disparity between corporate and noncorporate business forms by enacting two com-

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1. I.R.C. § 1244 (1982 & West Supp. 1985).

2. Mills, *Section 1244: A Tax Benefit With Very Little Burden*, 64 A.B.A. J. 480, 480-85 (1978).

3. Ruddy, *Section 1244: Legal Malpractice and the Passive Income Test*, 7 BARRISTER, Summer 1980, at 21, 21-22.

4. See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 4.11 (1979); see also W. PAINTER, *BUSINESS PLANNING: PROBLEMS AND MATERIALS* § 4.4 (2d ed. 1984) (discussing § 1244).

5. B. BITTKER & J. EUSTICE, *supra* note 4, ¶ 4.11. Generally a partner may deduct losses to the extent of his basis in the partnership, which is the amount of property and money contributed, adjusted for prior profits and losses. I.R.C. § 704(d) (West 1982); *id.* § 465 (1982 & West Supp. 1985) (limiting deductions to amount "at risk").

pensatory changes to the Code.⁶ The first change, subchapter S,⁷ exempts certain corporations from the corporate income tax and passes the corporation's income and losses directly to the corporation's shareholders.⁸ The second change, section 1244, allows certain stockholders to deduct realized losses on corporate stock as ordinary losses. This Article discusses section 1244, its requirements, effects, and problems.

I. AN INTRODUCTION TO SECTION 1244

Congress enacted section 1244 to encourage the flow of funds into small businesses and to place stockholders of small corporations on a more nearly equal basis with proprietors and partners.⁹ Under this provision, a loss on section 1244 stock that a corporation issued to an individual or partnership is an ordinary loss instead of a capital loss.¹⁰ Consequently, if a class of stock meets the detailed requirements of section 1244, holders of the stock may be in a better position than the owners of unincorporated businesses.¹¹ A proprietorship or a partnership can deduct only actual losses and cannot convert capital losses into ordinary losses. The owner of section 1244 stock, however, may recognize an ordinary loss even when the corporation operates profitably but the stock's value plummets solely due to external market factors.¹² Thus, section 1244 provides a type of insurance against some of the losses that small businesses frequently incur.¹³

Despite the broad purposes envisioned by Congress when enacting section 1244, detailed requirements must be met in order to insure the availability of the section 1244 deduction. Generally, the requirements fall into three main categories: the stock, the corporation, and the stockholder.¹⁴

A. The Stock

The stockholder can claim an ordinary loss only on the sale or exchange

6. Small Business Tax Revision Act of 1958, Pub. L. No. 85-866, 72 Stat. 1676.

7. I.R.C. §§ 71-79 (1982 & West Supp. 1985).

8. A detailed discussion of subchapter S is beyond the scope of this Article. For further study regarding subchapter S, see Bolt, *Highlights of the Subchapter S Revision Act of 1982*, 57 FLA. B.J. 166 (1983); Crumbley & Davis, *Tax Planning for Shareholders of Subchapter S Corporations*, 26 TAX L. REV. 643 (1971); Egerton & Rief, *Interrelationship of Subchapter S and Subchapter C*, 22 U. FLA. L. REV. 415 (1970); McGaffey & Garmer, *Taxation of Subchapter S Corporations and Their Shareholders*, 53 MARQ. L. REV. 1 (1970); Silversmith, *Tax Changes Affecting Subchapter S Corporations*, 69 A.B.A. J. 1251 (1983); Comment, *Passive Income and the Tax Option Corporation*, 25 BAYLOR L. REV. 469 (1973).

9. H.R. REP. NO. 2198, 85th Cong., 1st Sess. 4 (1958), reprinted in 1959-2 C.B. 709, 711.

10. I.R.C. § 1244(a) (West 1982).

11. For example, suppose a small business owner invests his corporation's funds in negotiable bonds. If interest rates rise, decreasing the value of that investment, § 1244 allows him to liquidate the corporation and convert the capital loss on the bonds into an ordinary loss since the value of his stock will have decreased commensurately with the loss on the bonds. Partners and proprietors, however, cannot convert the capital loss.

12. Suppose a small corporation owns buildings or land that decrease in value. If the owner liquidates his corporation, the decrease in value becomes a deductible ordinary loss rather than a capital loss.

13. See W. PAINTER, *supra* note 4, § 4.4.

14. Fisher, *Section 1244 Stock—Something for Nothing*, 5 BOSTON B.J. 7, 8 (1961).

of section 1244 stock. To qualify as section 1244 stock, the stock must be common or preferred stock of a domestic corporation¹⁵ and must be issued for either money or property.¹⁶ Both voting and nonvoting stock may qualify as section 1244 stock,¹⁷ but securities convertible into stock and stock convertible into other securities do not qualify.¹⁸ The aggregate amount of the taxpayer's section 1244 loss for any taxable year cannot exceed \$50,000 for an individual, or \$100,000 in the case of a husband and wife who file a joint return.¹⁹ If a taxpayer realizes a loss in excess of the amount allowed under section 1244, the taxpayer must recognize the excess as a capital loss.²⁰ On the other hand, if a taxpayer cannot recognize his entire section 1244 loss due to a low taxable income, the taxpayer may treat the unused loss up to the annual limit as part of his net operating loss, which he can carry back three years or carry forward seven years.²¹ Finally, the issuing corporation must designate which shares are section 1244 stock,²² since the corporation may issue different classes or issues of equity securities.

B. The Corporation

To qualify stock under section 1244, the issuing corporation must be a bona-fide small business corporation at the time the stock is issued.²³ A corporation is a small business corporation if the aggregate amount of money and other property that the corporation receives for its stock, as a contribution to capital and as paid in surplus, does not exceed one million dollars.²⁴ The stockholder's adjusted basis in transferred property, not the fair market value, determines the value of property transferred under section 1244.²⁵

The amount received for stock includes amounts received for all stock,

15. See I.R.C. § 1244(c)(1) (West Supp. 1985). The statute originally required that all § 1244 stock be common stock. The Tax Reform Act of 1984, however, reworded this section to eliminate the word "common." Tax Reform Act of 1984, Pub. L. No. 98-369, § 481(a), 98 Stat. 494, 847. Consequently, preferred stock issued after July 18, 1984, qualifies for ordinary loss treatment. See *id.* § 481(b); H.R. REP. NO. 432, 98th Cong., 2d Sess., part 2, at 1581 (1984).

16. I.R.C. § 1244(c)(1)(B) (1982 & West Supp. 1985); Treas. Reg. § 1.1244(c)-1(d)(1) (1981). The term "property" does not include stocks or securities. *Id.* Moreover, stock issued for services rendered or to be rendered does not qualify. *Id.*

17. See Treas. Reg. § 1.1244(c)-1(b) (1981). The IRS has not yet amended these regulations to conform to the 1984 statutory change that allows preferred stock to be § 1244 stock.

18. *Id.*

19. I.R.C. § 1244(b) (West 1982). The \$100,000 limit applies to all joint returns, even if only one spouse sustained the total loss. Treas. Reg. § 1.1244(b)-1(b)(ii) (1981). Moreover, a separate determination of the limitation applies to each partner if a partnership holds the stock. *Id.* § 1.1244(b)-1(a).

20. Treas. Reg. § 1.1244(b)-1(a) (1981).

21. I.R.C. § 1244(d)(3) (West Supp. 1985); Treas. Reg. § 1.1244(d)-4(a) (1960); see also I.R.C. § 172 (West Supp. 1985) (net operating loss carryback and carryforward provisions).

22. S. REP. NO. 1263, 95th Cong., 2d Sess. 158-60 (1978).

23. I.R.C. § 1244(c)(1)(A) (1982 & West Supp. 1985).

24. *Id.* § 1244(c)(3)(A).

25. *Id.* § 1244(c)(3)(B). The corporation values the money and other property received at its adjusted basis to the corporation less any liabilities to which the property is subject. *Id.* Note that no proscription exists in § 1244 to limit a corporation from expanding beyond this one million dollar limit through additional stock offerings.

including previously issued stock and preferred stock issued after July 18, 1984.²⁶ When determining the amount of money and other property received, subsequent distributions to shareholders, including capital distributions, redemptions, and partial liquidations, do not reduce the amount.²⁷ The net effect of this limitation is to restrict section 1244 treatment to stock issued in return for the first million dollars of corporate equity.

In addition to being a small business corporation when issuing the section 1244 stock, the corporation must also be an operating small business when the stockholder sustains his loss. To qualify as an operating small business, during the five taxable years preceding the date of the loss the corporation must have derived more than one-half of its aggregate gross receipts from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.²⁸ If the corporation has not existed for five years, section 1244 specifies a shorter period.²⁹ Congress designed this restriction to prevent a stockholder from recognizing an ordinary loss when the corporation engages primarily in investment activities that would produce capital losses if conducted in the stockholder's individual capacity.³⁰ The gross receipts limitation, however, does not apply if the corporation's deductions exceed its gross income.³¹

C. The Stockholder

Section 1244 restricts eligible stockholders in several ways. First, only individual stockholders may utilize section 1244.³² Nonindividual stockholders, such as trusts and estates, may not claim section 1244's benefits.³³ If a partnership owns section 1244 stock, the partnership may pass on section 1244 losses to the individual partners.³⁴ Second, the individual or part-

26. See *supra* note 15 and accompanying text.

27. Treas. Reg. § 1.1244(c)-2(b)(1) (1982); Fisher, *supra* note 14, at 8-9; Silverberg, *Code Provides Risk-Free Method of Converting Capital Loss Into an Ordinary Deduction*, 12 TAX'N FOR LAW. 24, 25 (1983).

28. I.R.C. § 1244(c)(1)(C) (1982 & West Supp. 1985); Treas. Reg. § 1.1244(c)-1(e)(1)(i)(a) (1981). In *Brown v. Commissioner*, 38 T.C.M. (CCH) 91, 92-93 (1979), the court ruled that § 1244 was not available to an individual who claimed an ordinary loss on his investment in a horse-betting system. The court stated that the corporation "not only failed to meet the 'operating company' test, but was a 'paper company'" through which the individual attempted to convert a nondeductible wagering loss into a § 1244 ordinary loss. *Id.* at 93.

29. I.R.C. § 1244(c)(2)(A) (1982 & West Supp. 1985).

30. See B. BITTKER & J. EUSTICE, *supra* note 4, ¶ 4.11.

31. I.R.C. § 1244(c)(2)(C) (1982 & West Supp. 1985); see *Bates v. United States*, 581 F.2d 575, 580 (6th Cir. 1978); *Davenport v. Commissioner*, 70 T.C. 922, 926 (1978); *Mills, supra* note 2, at 484-85.

32. I.R.C. § 1244(a) (West 1982); Treas. Reg. § 1.1244(a)-1(b) (1981). The regulations limit § 1244 to individuals or to individuals who are partners in a partnership when the corporation issues the § 1244 stock to the partnership, provided that each partner's distributive share of partnership items reflects the partnership loss. *Id.* § 1.1244(a)-1(b)(2).

33. I.R.C. § 1244(d)(4) (West 1982).

34. Treas. Reg. §§ 1.1244(a)-1(b), (c) ex. 1 (1981). The example states that if two individuals and a trust are equal partners in a partnership that owns § 1244 stock, the two individuals may classify their distributive shares of the § 1244 loss as ordinary losses when the partnership sells the stock, but the trust may not classify its distributive share as an ordinary loss. *Id.*

nership must have held the stock since the date of issuance.³⁵ Vendees, donees, and other transferees cannot qualify for section 1244 losses. The use of the term "issuance" in the regulations restricts the benefit of section 1244 to those individuals or partnerships that invest funds or property directly into the corporation.³⁶

Third, the continuous ownership requirement will disqualify losses on section 1244 stock that is originally issued to a partnership but subsequently is distributed to the partners. The section 1244 loss is not available to the partners because they did not acquire the stock by issuance from a small business corporation.³⁷ Moreover, if an existing corporation repurchases outstanding stock that originally met the requirements of section 1244, the repurchase may be sufficient to cancel section 1244 status as to the shares repurchased even if the corporation reissues the shares at a later date, *unless* the reissuance of that stock results in additions to the corporation's equity capital.³⁸

Finally, if a corporation attempts to issue section 1244 stock to the public through an investment banking firm, the purchase of stock by an underwriter and subsequent resale of the stock to brokerage house customers will terminate the section 1244 status of the stock.³⁹ This termination occurs because the customer is not the original purchaser of the stock.⁴⁰ An exception to this rule exists, however, with respect to a "best efforts" underwriting, in which the underwriter acts as the agent of, rather than underwriter for, the issuer.⁴¹ This exception, however, is rarely used today. One commentator states that the regulation's approach seems unduly technical and unjustified by the statutory terminology.⁴²

II. ADDITIONAL SECTION 1244 REQUIREMENTS

The taxpayer or corporation must meet further specific requirements to qualify stock for section 1244 treatment. These further requirements concern high basis property transferred to the corporation, the plan requirement

35. *Id.* § 1.1244(a)-1(b)(2).

36. See B. BITTKER & J. EUSTICE, *supra* note 4, ¶ 4.11; Cannon, *The Small Business Corporation Losses, An Important Deduction to Gain: A Checklist*, 29 N.Y.U. INST. ON FED. TAX'N 839, 843-44 (1971); Comment, *Section 1244 Small Business Stock—Professional Responsibility Demands Its Use*, 10 U. RICH. L. REV. 355, 356 (1976).

37. Treas. Reg. § 1.1244(a)-1(c) ex. 2 (1981). To qualify for § 1244 treatment a stockholder must establish that his investment in the small business corporation's stock actually increased the corporation's capital. See *Rookard v. United States*, 330 F. Supp. 722, 724 (D. Ore. 1971).

38. *Adams v. Commissioner*, 74 T.C. 4, 12 (1980).

39. Treas. Reg. § 1.1244(a)-1(b)(2) (1981). An underwriter either purchases stock from or sells stock for an issuer or control person.

40. I.R.C. § 1244(a) (West Supp. 1985).

41. Treas. Reg. § 1.1244(a)-1(b)(2) (1981). In a "best efforts" underwriting the underwriter does not take any stock for his own account, but merely acts as agent for the issuer. A similar situation occurs if the underwriter acts as a standby underwriter, which agrees to purchase all stock not sold to the public. In either case, the stock that the public acquires is not tainted, and § 1244 will apply. See M. BUDD & N. WOLFSON, *SECURITIES REGULATION 64-65* (1984); L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION 277-96* (1983).

42. See W. PAINTER, *supra* note 4, § 4.4 (statute only requires that stock have been issued to the person claiming the loss).

for taxable years ending before November 6, 1978,⁴³ and additional stock issuances after an initial offering.

One area of difficulty under section 1244 arises when a taxpayer transfers property with a basis in excess of its fair market value to a corporation. Generally, if a taxpayer transfers high basis property in exchange for stock, the taxpayer's basis in the property becomes his basis in the stock.⁴⁴ When the stockholder computes his section 1244 ordinary loss on the sale of the stock, however, he must reduce the basis of the stock by the excess of the adjusted basis of the transferred property over its fair market value on the date of transfer.⁴⁵ This reduction prevents an individual from immediately selling newly issued stock at a loss and receiving an ordinary deduction on the entire amount of the loss.

The following example illustrates the operation of this rule.⁴⁶ An individual owns a capital asset with an adjusted basis of \$10,000 and a fair market value of \$6,000. Pursuant to a tax-free incorporation,⁴⁷ the individual transfers the property to a corporation in exchange for section 1244 stock. The basis of the section 1244 stock would ordinarily be \$10,000. This special rule, however, reduces the basis by \$4,000 for purposes of section 1244. If the individual subsequently sells the section 1244 stock for \$6,000, then he would not recognize an ordinary loss. Nevertheless, he would recognize a \$4,000 capital loss since this special rule affects only the character, and not the amount, of the loss.⁴⁸ If the individual exchanges more than one item of property for section 1244 stock, the regulations require the individual to allocate his basis among the stock received.⁴⁹ The individual thus must aggregate all market values and basis amounts, divide those amounts by the number of shares received, and allocate the resulting per share amount to each share.⁵⁰ This multiple item rule assures that a loss will qualify under section 1244 only to the extent of money or property originally paid for the stock.⁵¹

43. The Revenue Act of 1978, Pub. L. No. 95-600, § 345, 92 Stat. 2763, 2844-45, substantially altered the construction of § 1244. Many of the restrictions and rules discussed in this section and the following section of this Article are the direct result of the changes promulgated by the 1978 Act. See also Revenue Act of 1978, S. REP. NO. 1263, 95th Cong., 2d Sess. 158-60 (1978). See generally Barrack & Dodge, *Section 1244, Is the Intent of Congress Finally Achieved?*, 6 J. CORP. TAX'N 283, 289-90 (1980).

44. I.R.C. § 1244(d)(1)(A) (West 1982).

45. *Id.*; Treas. Reg. § 1.1244(d)-1(a)(1) (1960). The regulations require that the taxpayer make the computation using the values that existed immediately before the exchange. *Id.*

46. The example is taken from Silverberg, *supra* note 27, at 28.

47. See I.R.C. § 351 (1978 & West Supp. 1985).

48. If in this example the individual sold the stock for \$5,000 instead of \$6,000, the individual would recognize a \$4,000 capital loss and a \$1,000 ordinary loss. The special basis rule does not affect the stock's basis for purposes other than § 1244. Treas. Reg. § 1.1244(d)-1(a)(2) (1960).

49. *Id.* § 1.1244(d)-1(b).

50. *Id.* § 1.1244(d)-1(c) ex. 3. If subsequent to the corporation's issuance of the stock an increase in the stock's basis occurs, the taxpayer must allocate the increase to the stock that is not § 1244 stock. Cf. *id.* § 1.1244(d)-2(b) ex. 1 (allowing stockholder to deduct only part of additional capital contribution relating to § 1244 stock as an ordinary deduction).

51. See B. BITTKER & J. EUSTICE, *supra* note 4, ¶ 4.11.

Of all of the original requirements that Congress imposed on section 1244 stock, the most restrictive and problematic was the necessity to adopt a qualified plan.⁵² Generally, the statute required that a plan specify when the corporation would issue the stock.⁵³ The period could not exceed two years after the date of plan adoption.⁵⁴ Moreover, the regulations required the plan to specify the maximum amount of money and other property to be received from the stock offering.⁵⁵ The burden of proving the existence of a plan rested on the taxpayer.⁵⁶ The necessity of a plan, however, led to uneven treatment of small business owners. Consequently, in 1978 the Senate Finance Committee recommended that Congress eliminate the written plan requirement.⁵⁷ Accordingly, Congress removed the plan requirement for stock issued after November 6, 1978.⁵⁸ The regulations recommend, however, that a corporation keep detailed records of any plan and stock issuances thereunder if the corporation issued stock before November 7, 1978.⁵⁹

Finally, a problem exists concerning additional stock issuances. Although prior law limited total equity capital of a small business corporation to one million dollars or less at the time of issuance of section 1244 stock,⁶⁰ the Revenue Act of 1978 amended this limitation to provide that the corporation may issue additional equity capital.⁶¹ A corporation qualifies its stock for section 1244 treatment if the total amount of money and other property received as capital and capital surplus on all stock offerings does not exceed one million dollars when the corporation issues the section 1244 stock. The transition year rule comes into play, however, in the year in which the corporation's capital exceeds one million dollars.⁶²

The transition year rule requires the corporation to designate which stock issued in that year qualifies as section 1244 stock.⁶³ Since amounts received

52. Barrack & Dodge, *supra* note 43, at 286.

53. I.R.C. § 1244(c)(1)(A), *repealed by* Revenue Act of 1978, Pub. L. No. 95-600, § 345, 92 Stat. 2763, 2844-45.

54. *Id.*

55. Treas. Reg. § 1.1244(c)-2(c)(1) (1965), *amended by* T.D. 7779, 46 Fed. Reg. 29, 468 (1980); Mills, *supra* note 2, at 481. For a complete analysis of the plan requirement, see Taylor & Tripp, *Section 1244: Avoiding Its Problems*, 29 N.Y.U. INST. ON FED. TAX'N 201, 203-16 (1971).

56. In many cases, this burden was not easily met. For example, although most practitioners believed that a board resolution and entry in the minutes book would sufficiently prove the existence of a plan, corporate entries that contained less than all of the required provisions did not suffice. *Childs v. Commissioner*, 408 F.2d 531, 533 (3d Cir. 1969); *Kaplan v. Commissioner*, 59 T.C. 178, 187 (1972). Similarly, a lawyer's notations did not equal a written plan. *Spiegel v. Commissioner*, 49 T.C. 527, 532 (1968).

57. S. REP. NO. 1263, 95th Cong., 2d Sess. 159 (1978).

58. Revenue Act of 1978, Pub. L. No. 95-600, § 345, 92 Stat. 2763, 2844-45.

59. Treas. Reg. § 1.1244(e)-1(a)(1) (1981) (recordkeeping mandatory for corporations); *Id.* § 1.1244(e)-1(b) (owner of § 1244 stock required to maintain records sufficient to distinguish that stock from any other stock he may own).

60. I.R.C. § 1244(c)(2), *amended by* Revenue Act of 1978, Pub. L. No. 95-600, § 345, 92 Stat. 2763, 2844-45.

61. See S. REP. NO. 1263, 95th Cong., 2d Sess. 159 (1978).

62. Treas. Reg. § 1.1244(c)-2(b)(2) (1982). The regulations define the transitional year as the first tax year when capital receipts exceed one million dollars and the corporation issues stock. *Id.*

63. *Id.* § 1.1244(c)-2(b)(2)(i).

for designated stock cannot exceed one million dollars, only some of the shares issued in the transitional year can qualify.⁶⁴ The corporation, not the shareholder, makes the designation.⁶⁵ The corporation makes the designation by entering the numbers of the qualifying stock certificates in the corporation's records.⁶⁶ The corporation must specifically identify the qualifying certificates; merely specifying an indistinguishable part of a block of stock is insufficient.⁶⁷ Failure to designate properly the qualifying stock results in a proportional allocation.⁶⁸ The stockholder may only claim an ordinary loss in an amount that bears the same ratio to the total loss sustained as the amount equal to one million dollars minus capital received before the transition year divided by the total money and other property received by the corporation as equity capital contributions in the transitional year.⁶⁹ The corporation must designate the section 1244 stock in the corporation's records by the fifteenth day of the third month following the close of the transitional year to avoid the proportional allocation.⁷⁰ If the corporation's fiscal year does not coincide with the calendar year, one must take care to assure compliance with this designation rule.

III. PROBLEM AREAS

The foregoing sections of this Article address section 1244 requirements. Several additional problems may arise in connection with section 1244 that the Code and regulations do not sufficiently cover. Surprisingly, these difficulties are quite common occurrences rather than the isolated situations that one might assume.

A. The Debt-Equity Problem

A problem arises when stockholders who loan money to a corporation wish to take advantage of section 1244. Generally, the Code treats a stock-for-debt transaction as an exchange for money or other property unless the cancelled debt arose from the performance of personal services.⁷¹ If, however, the IRS treats the debt as equity, stock subsequently issued in exchange

64. *Id.*

65. *Id.* §§ 1.1244(c)-2(b)(2)(iii), -2(b)(4) ex. 2.

66. *Id.* § 1.1244(c)-2(b)(2)(iii).

67. *Id.* § 1.1244(c)-2(b)(4) ex. 2.

68. *Id.* § 1.1244(c)-2(b)(3)(iii).

69. The formula is:

$$\frac{\text{the 1244 loss}}{\text{the total loss}} = \frac{\$1,000,000 - \text{post-1958 capital received before the transition year}}{\text{capital received during the transition year}}$$

Id.

70. *Id.* § 1.1244(c)-2(b)(2)(iii).

71. *Id.* § 1.1244(c)-1(d)(1) (1981). In Rev. Rul. 66-293, 1966-2 C.B. 305, the IRS stated that the regulations do not characterize the nature of the consideration given for stock, but merely provide that stock issued in consideration for cancellation of indebtedness of the corporation may qualify as § 1244 stock. *Id.*

for cancellation of the debt will not qualify for the ordinary loss deduction.⁷² In *Hollenbeck v. Commissioner*⁷³ the court determined that section 1244 was not available because stockholder loans to the corporation were, in fact, equity.⁷⁴ Accordingly, when the corporation issued the ostensible section 1244 stock in exchange for cancellation of the loan, the corporation was really exchanging stock for stock.⁷⁵ Section 1244 was unavailable to the stockholder when he later sold the stock received because he did not receive that stock in exchange for money or property.⁷⁶ Thus, when debt functionally constitutes risk capital, a court will treat the formal conversion of the debt into stock as an exchange of one equity interest for another, rather than as an exchange of money or other property for stock.

A potential solution to the debt-equity problem already exists in a related context. In section 1361(c)(5) Congress created a safe-harbor rule to prevent the IRS from asserting that debt is really equity in S corporations.⁷⁷ Generally, this section presumes that when the debtor corporation couples a promise to pay money on demand or at a specified time with a reasonable interest rate, the loan will not constitute equity for tax purposes unless it is convertible to stock or is held by an ineligible person.⁷⁸ Although this safe-harbor rule presently applies only to S corporations, extending the rule to section 1244 seems both logical and desirable since Congress enacted subchapter S and section 1244 for the same purpose.⁷⁹ Such an extension would virtually eliminate the type of debt-equity problem raised in the *Hollenbeck* case.

Some courts have not granted section 1244 treatment to stock issued for cancellation of indebtedness if the sole purpose of the cancellation was to gain section 1244 treatment. In *Hollenbeck v. Commissioner* the court held that stockholder's only purpose for cancelling the debt was to obtain advantageous tax treatment.⁸⁰ The court stated that such a purpose, without any business purpose to the corporation, was insufficient to bring the transaction within section 1244.⁸¹ Consequently, if a conversion of debt to equity serves

72. The safe-harbor rules pertaining to debt of S corporations may somewhat temper this situation. See I.R.C. § 1361(c)(5) (West Supp. 1985).

73. 422 F.2d 2 (9th Cir. 1970).

74. *Id.* at 3-5. Whether advances to a corporation are contributions to capital or loans is a question of fact. The substance, not the form, of the transaction controls. When a stockholder attempts to characterize a loss of risk capital as a bad debt, a court will disallow the loss. *Lundgren v. Commissioner*, 376 F.2d 623, 626 (9th Cir. 1967); *Gilbert v. Commissioner*, 262 F.2d 512, 514 (2d Cir. 1959).

75. 422 F.2d at 3-5.

76. *Id.* The stockholder must receive the § 1244 stock in exchange for money or property other than stock or securities. I.R.C. § 1244(c)(1)(B) (1982 & West Supp. 1985).

77. I.R.C. § 1361(c)(5) (West Supp. 1985).

78. *Id.*

79. Both subchapter S and § 1244 arose from Congress's intent to encourage the flow of new funds into small business and to place stockholders of small corporations on a more nearly equal basis with proprietorships and partnerships. See H.R. REP. NO. 2198, 85th Cong., 2d Sess. 4 (1958) (discussing § 1244).

80. 422 F.2d at 6.

81. *Id.* The court believed that allowing § 1244 treatment without a commensurate business purpose would defeat Congress's intent. *Id.*

no economic purpose other than securing a tax benefit, section 1244 will not apply.

Courts have also applied a sham transaction analysis to deny section 1244 treatment when debt has been converted to equity. In *Bruce v. United States*⁸² the court denied ordinary loss treatment when an individual bought stock in an insolvent corporation and then forced the corporation to use the contributed money to repay an outstanding loan from the individual to the corporation.⁸³ The court held that creditors may not use section 1244 to bail out of insolvent businesses.⁸⁴ Moreover, in *Morgan v. Commissioner*⁸⁵ the court denied ordinary loss treatment when stockholders used payments received by a company in liquidation to pay a limited group of creditors, which included themselves.⁸⁶ Thus, courts look to the true purpose of the repayment before permitting taxpayers to swap debt for equity and thereafter receive section 1244 treatment.⁸⁷

In the above cases the courts could have based their decisions on statutory grounds without relying on such nebulous concepts as business purpose and sham transaction.⁸⁸ In each of the cases the corporation in which the taxpayer invested was insolvent and about to liquidate. The taxpayer's loan to the corporation had almost certainly gone bad before the corporation issued the purported stock. The taxpayer's loss, therefore, was a bad debt loss, the character of which the taxpayer determines under section 166.⁸⁹ Although this analysis would not change the result in any of the above cases, it offers a more objective approach for future situations.

B. The Gross Receipts Test

The gross receipts test is the primary test that the corporation must meet when the stockholder sustains his loss. The stock will not qualify as section 1244 stock unless, during the corporation's five most recent taxable years ending prior to the date the loss was sustained, the corporation derived greater than fifty percent of its gross receipts from sources other than rents, royalties, dividends, interest, annuities, and sales or exchanges of stocks or securities.⁹⁰ The regulations define gross receipts as the total amount accrued or received from all sources, including sales or exchanges of property, investments, and services.⁹¹ Gross receipts, however, do not include loan

82. 279 F. Supp. 686 (S.D. Tex. 1967), *aff'd*, 409 F.2d 1317 (5th Cir. 1969).

83. 279 F. Supp. at 689.

84. *Id.*

85. 46 T.C. 878 (1966).

86. *Id.* at 892-93.

87. Despite the general rule, the regulations specifically permit certain transactions in which the stockholder exchanges stock for stock. These transactions are: (1) stock dividends; (2) recapitalizations; and (3) reorganizations. Treas. Reg. § 1.1244(d)-3 (1981).

88. The sham transaction doctrine, however, will undoubtedly continue to be a necessary arrow in the Commissioner's quiver for cases in which bad debt analysis proves ineffective.

89. I.R.C. § 166 (1978 & West Supp. 1985).

90. *Id.* § 1244(c)(1)(C) (1982 & West Supp. 1985); Treas. Reg. § 1.1244(c)-1(e)(1)(i)(a) (1981).

91. Treas. Reg. § 1.1244(c)-1(e) (1981). Gross receipts include amounts received from the

proceeds or repayments, contributions to capital, or proceeds from the issuance of stock.⁹² The regulations generally do not include property received in a nontaxable sale or exchange in gross receipts, except to the extent that the corporation recognizes gain.⁹³ The regulations, however, include in gross receipts property received in a sale or exchange occurring within twelve months prior to a section 337 liquidation, even though the sale or exchange may be nontaxable under section 337.⁹⁴

Congress intended the passive income test to deny section 1244 treatment to investment and holding companies.⁹⁵ This operating company requirement, however, could pose serious problems if the courts apply the requirement too literally.⁹⁶ The recent case of *Davenport v. Commissioner*⁹⁷ is a timely example.

In *Davenport* the tax court ruled that a corporation that derived more than one-half of its gross receipts from interest was not an operating company.⁹⁸ Consequently, the corporation's stock did not qualify as section 1244 stock.⁹⁹ The taxpayer argued that an exception to the gross receipts test preserved his stock's section 1244 status. The exception provides that the gross receipts test does not apply if, during the period of the five tax years preceding the stockholder's loss, the allowable deductions of the corporation exceed its gross income.¹⁰⁰ The IRS, however, argued that the court should limit this exception to "operating companies that never got off the ground."¹⁰¹

The court agreed with the IRS.¹⁰² A corporation thus must be an operating company to qualify for the exception.¹⁰³ According to the court, Congress designed the exception to avoid disqualifying operating companies that report large amounts of passive income because of unsuccessful operations.¹⁰⁴ Congress's intent was not to provide investment companies with

sale or exchange of stock or securities only to the extent of the gains realized. *Id.* § 1.1244(c)-2(g)(vii) (1981).

92. *Id.* § 1.1244(c)-1(e)(1)(i)(a).

93. *Id.*

94. *Id.*; I.R.C. § 337 (1978 & West Supp. 1985).

95. See H.R. REP. NO. 2198, 85th Cong., 1st Sess. 1 (1958), reprinted in 1959-2 C.B. 709, 709.

96. See Taylor & Tripp, *supra* note 55, at 227.

97. 70 T.C. 922 (1978).

98. *Id.* at 930.

99. *Id.*

100. I.R.C. § 1244(c)(2)(C) (1982 & West Supp. 1985).

101. 70 T.C. at 926. Neither the section nor its legislative history appears to support the IRS's assertion. Barrack & Dodge, *supra* note 43, at 294 n.38. The regulations, however, state that ordinary loss treatment is not available to stock of a corporation that is not largely an operating company during the five most recent tax years "or such lesser period" as the corporation exists. Treas. Reg. § 1.1244(c)-1(g) (1981). The IRS may have interpreted the "lesser period" language to apply only to corporations that "never got off the ground," without considering the exception available when allowable deductions exceed gross income.

102. See 70 T.C. at 928-29.

103. The court pointed out that in creating the exception to the gross receipts test, "nowhere did Congress indicate that the overall 'largely operating company' limitation was to be ignored." *Id.* at 928.

104. *Id.* at 928-29. Consider the corporation that has cash invested in interest-bearing ac-

section 1244 benefits.¹⁰⁵

The corporation in *Davenport v. Commissioner* was a small loan company. Even if that corporation had been profitable, most of its income would have been passive interest. Consequently, if a court looks only to the plain meaning of the words used to define passive income,¹⁰⁶ a court will deny even operating finance companies the use of section 1244. In *Bates v. United States*¹⁰⁷ the court appears to take this position. In that case the court stated that to be an operating company a corporation must receive more than fifty percent of its gross receipts from nonpassive sources.¹⁰⁸ The courts thus appear to exclude some corporations that actively engage in business from using section 1244 since the statute discriminates on the basis of the type of income rather than the income-producing activity.¹⁰⁹

The denial of section 1244 benefits to operating companies that derive their income from interest, royalties, or like sources seems unfair. The purpose of the gross receipts test is to prevent the conversion of capital losses to ordinary losses by transferring investment property to a corporation in exchange for section 1244 stock.¹¹⁰ Extending section 1244 treatment to the stock of corporations that derive their operating income from interest, royalties, or like sources would not frustrate section 1244's purpose.

One way to remedy the problem of corporations receiving tainted operating income would be to look to the nature of the assets producing the income. If, in the corporation's hands, a loss on disposition of the asset would constitute a loss other than a capital loss, the income generated by the asset should be excluded from the scope of section 1244(c)(1)(C).¹¹¹ When characterizing debt obligations for this purpose, the nonbusiness debt rules of section 166(d)¹¹² should be applied as though the corporation were an

counts during a business downturn. Investment income might offset operating losses. Since the corporation is unable to meet the gross receipts test due to operational losses, and not due to the firm's investment policy, denying § 1244 treatment is inappropriate.

105. *Id.* at 929.

106. *Cf. Buhler Mortgage Co. v. Commissioner*, 51 T.C. 971, 978 (1969) (interpreting subchapter S provisions), *aff'd*, 443 F.2d 1362 (9th Cir. 1971).

107. 581 F.2d 575 (6th Cir. 1978).

108. *Id.* at 579. A dissenting opinion in *Davenport v. Commissioner*, however, raised this exact dilemma. Judge Wilbur found irony in the result that a financing corporation was not an operating company. 70 T.C. at 943 (Wilbur, J., dissenting).

109. The regulations attempt to correct this position with respect to rental income. The regulations exclude from the definition of rent amounts received for the use or occupancy of property if the occupant receives significant services. Treas. Reg. § 1.1244(c)-1(g)(1)(iii) (1981). No similar exclusions exist, however, with respect to other sources of potentially passive income.

110. B. BITTKER & J. EUSTICE, *supra* note 4, ¶ 4.11; S. LIND, S. SCHWARZ, D. LATHROPE & J. ROSENBERG, *FUNDAMENTALS OF CORPORATE TAXATION* 124 (1985). The House Committee report, though, states that the purpose of the gross receipts test is to restrict § 1244 treatment to the stock of "largely operating companies." H.R. REP. NO. 2198, 85th Cong., 1st Sess. 1 (1958), *reprinted in* 1959-2 C.B. 709, 709.

111. Alternatively, Congress might adopt the following two-part test. If either the corporation or the stockholder desiring § 1244 treatment would realize a capital loss on disposition of the underlying property, the property retains the passive income taint.

112. I.R.C. § 166(d) (1978 & West Supp. 1985). Section 166(d) characterizes bad debt losses incurred by taxpayers other than corporations as short-term capital losses, unless the taxpayer made the loan in connection with his trade or business. *Id.*

individual.

A literal application of the operating company requirement could preclude businesses that serve depressed markets from using section 1244. Consider a corporation that issues section 1244 stock and then has its sales shrink because of a downturn in its markets. If the corporation has invested a reasonable amount of cash in interest-bearing instruments, over one-half of its income may derive from passive sources. If the stockholders do not dissolve the corporation quickly, they may lose section 1244 treatment of their stock because of the nonoperating company doctrine.¹¹³ Congress did not intend such a result.¹¹⁴ Reform is necessary in order to overcome such unintended, onerous results.

C. Partnership Incorporation

A problem may arise when incorporating a partnership. To qualify for section 1244 treatment, the regulations require the individual or partnership sustaining the loss on the stock to have held the stock continuously from the date of issuance.¹¹⁵ Thus, ordinary loss treatment is unavailable to a partner to whom the partnership distributed the stock.¹¹⁶ Although the partners can incorporate a partnership in several ways,¹¹⁷ in Revenue Ruling 70-239¹¹⁸ the IRS stated that it would view such incorporations as if the partnership transferred the partnership assets to the new corporation for stock, then distributed that stock to the partners.¹¹⁹ Consequently, the IRS will deem the stock that the partners receive from incorporating their partnership to have passed from the new corporation to the partnership and then to the partners, regardless of how the partners actually structured the incorporation.¹²⁰ Combining the revenue ruling with the regulations, stock issued in connection with a partnership incorporation cannot constitute section 1244 stock unless the partnership continues in existence to hold the stock.¹²¹ Any subsequent transfer by the partnership, the original recipient of the stock, disqualifies the stock from section 1244 treatment.

The IRS revoked Revenue Ruling 70-239 in Revenue Ruling 84-111.¹²² Assuming that the partnership transferred its assets to a corporation for valid business reasons and the transfer was not a device to avoid or evade recognition of gain, three possible methods of incorporating a partnership

113. Barrack & Dodge, *supra* note 43, at 295-96; Taylor & Tripp, *supra* note 55, at 227-28.

114. Congress enacted § 1244 to provide benefits for investments in small businesses that both succeed and fail. H.R. REP. NO. 2198, 85th Cong., 2d Sess. 1 (1958).

115. Treas. Reg. § 1.1244(a)-1(b)(2) (1981).

116. *Id.* § 1.1244(a)-1(c) ex. 2.

117. The partners could either: (1) transfer their partnership interests to the new corporation in exchange for stock; or (2) liquidate the partnership and then transfer the distributed assets to the new corporation in exchange for stock. See Fleming, *The Unfinished Business of Section 1244: Removing the Remaining Traps*, 58 TAXES 713, 716 (1980).

118. 1970-1 C.B. 74.

119. *Id.*

120. Fleming, *supra* note 117, at 716. The IRS treated the partnership not as a mere conduit, but as the real stockholder. *Id.*

121. See B. BITTKER & J. EUSTICE, *supra* note 4, ¶ 3.18; Mills, *supra* note 2, at 480 n.5.

122. 1984-2 C.B. 88.

are now permitted,¹²³ allowing taxpayers to avoid the potential pitfalls brought about by Revenue Ruling 70-739. Consequently, if partners transfer their partnership interests to a newly formed corporation in exchange for stock, each partner will constitute the original recipient of the stock, and the stock will thus qualify for section 1244 treatment in the hands of the former partners, provided that all other basic requirements of the section are also met.¹²⁴

On the other hand, if the basic assumption of Revenue Ruling 70-239 continues, the transferors will be required to select a proper method of transfer to assure section 1244 status. Thus, if the partners structure the incorporation so that the corporation issues the stock to the partnership, then the subsequent distribution of stock by the partnership to the partners will still deny the partners section 1244 treatment because of the intermediate ownership of the stock by the partnership.¹²⁵ The partners thus must pay careful attention to the details of the transfer arrangements to insure that either: (1) the partnership distributes the partnership assets to the partners, who then transfer those assets to the corporation in exchange for stock; or (2) the partners transfer their partnership interests to the corporation in exchange for stock.

Revenue Ruling 84-111 thus permits alternative methods of incorporating a partnership, but the question remains as to whether the intent of Congress, at least as to section 1244, is achieved. A further articulation on the subject is necessary because an inadvertent transfer could cause the stock to lose section 1244 status during a partnership incorporation. The IRS should rule that the partnership merely acts as a conduit¹²⁶ and does not constitute a holder of the stock for purposes of section 1244 under any method of incorporation. If the IRS adopts this position, then section 1244 will cease to pose a trap for the unwary and will always be available to the "original" stockholders. We believe this view best represents Congress's intent in enacting section 1244.

IV. CONCLUSION

Congress enacted section 1244 in 1958 to stimulate investment in small business. Although originally designed with simplicity in mind, section 1244 was for years mired in technical and administrative difficulty and consequently required repair. The Revenue Act of 1978 provided some relief, but several problem areas still remain. The operating company restrictions and

123. See Rev. Rul. 84-111, 1984-2 C.B. 88 (this ruling was not made retroactive); *supra* note 26 and accompanying text for descriptions of the three acceptable methods of transfer.

124. The revocation of Revenue Ruling 70-239 eliminated the tension between the election of § 1244 and the election of subchapter S in the same stock. Revenue Ruling 70-239 forced the partnership to remain the holder of the stock to qualify for § 1244 treatment. Rev. Rul. 70-239, 1970-1 C.B. 74. A partnership, however, may not own subchapter S stock. I.R.C. § 1361(b)(1)(B) (West Supp. 1985).

125. See Rev. Rul. 84-111, 1984-2 C.B. 88. Only an original holder can qualify for § 1244 treatment. See *supra* text accompanying notes 35-37.

126. Fleming, *supra* note 117, at 717.

the personal loan situations reflect the continuing uncertainties surrounding designations of section 1244 stock. Even though the IRS has partially clarified the partnership incorporation problem, much still remains for the IRS to do in that area. In the future courts will undoubtedly rule on these and other difficult questions. We only hope that those courts bear in mind Congress's intent to aid and encourage small business so that section 1244 will become a simplified and meaningful method of attracting capital.¹²⁷

127. H.R. REP. NO. 2198, 85th Cong., 1st Sess. 1 (1958), *reprinted in* 1959-2 C.B. 709, 709.