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The Issuance of Stock Under Section 1244 of the Internal Revenue Code

CARLE E. DAVIS

Prior to June 30, 1958, the loss on sale, liquidation or worthlessness of capital stock always resulted in a capital loss to the non-dealer individual stockholder. The limitations placed on the deductibility of a capital loss often operated to deny a tax deduction for a portion of such loss. On the other hand, proprietors and partners were usually permitted to deduct, as ordinary losses and without limitation, losses of capital invested in their businesses. In 1958, Congress, concerned with a somewhat sagging business economy, enacted the "Small Business Tax Revision Act of 1958". The Act created a new section, section 1244, and made substantial changes in four other sections of the Internal Revenue Code. The announced purposes of section 1244 were "to encourage the flow of new funds into small business" and to place the stockholders in small corporations (with respect to losses) "on a more nearly equal basis with . . . proprietors and partners". Unfortunately, the intended tax relief provided by section 1244 is not granted to the stockholder automatically and without limitation. The purpose of this brief note is to examine the provisions of section 1244 with a view toward qualifying for the tax benefits of that section.

Section 1244 deals specifically with the tax treatment of certain losses arising from the sale, liquidation, or worthlessness of common stock in a small business corporation. The section operates, within limitations, to convert what would otherwise be a capital loss into an ordinary loss. The conversion of the loss occurs only if (i) there is a qualifying stockholder who sustains a loss (ii) upon qualifying stock in (iii) a qualifying corporation.

Qualifying Stockholder

The qualifying stockholder must be an individual and he

must be an original stockholder. A corporation, trust, or estate is not a qualifying stockholder. A partner is a qualifying stockholder, if he was a partner in the partnership at the time the stock was acquired by the partnership from the corporation upon original issue, and if his distributive share of partnership loses reflects the stock loss. However, the partner who acquires stock as a distribution from his partnership is not a qualifying stockholder. There appears to be little justification for excluding the stockholder who acquires stock by purchase from another stockholder, or from his partnership, or by gift, inheritance, or other transfer, but such is the result.

Qualifying Corporation

The qualifying corporation must be a "small business corporation". Such corporation is defined in terms of its capital structure. Restrictions are placed on the aggregate amount received by the corporation for its stock, or as capital or surplus contributions, and on the amount of equity capital of the corporation. First, the corporation may not receive an aggregate amount of money or other property in excess of $500,000 after June 30, 1958, for its stock, as a contribution to capital, and as paid-in surplus. Secondly, the equity capital of the corporation cannot exceed $1,000,000.

In determining the amount of property other than cash received by the corporation for its stock or as a capital contribution, the property is taken into account at its adjusted basis to the corporation (for determining gain) as of the date it was received by the corporation less any liabilities to which the property was subject or any liabilities assumed by the corporation at such time. For example, if Corporation X, a newly-formed corporation, receives real estate from Y, an individual, in exchange for all of its capital stock, and the real estate has an adjusted basis of $550,000 in the hands of Y, and a fair market value of $750,000, and the real estate is subject to a deed of trust note of $50,000, the aggregate amount of property received is $500,000 ($550,000, adjusted basis, minus, $50,000, liability).

The total amount of money or other property received for stock or as a contribution to capital is not reduced by capital distributions or by redemptions and retirement of stock of the corporation.

If the corporation proposes to issue capital stock for cash and other property in excess of $500,000, consideration should be given to the issuance of debt obligations, bonds or short or long term notes, in lieu of stock. For example, if the corporation requires capital of $750,000 to finance its operations and issues stock for such amount, it will not qualify as a small business corporation. On the other hand, if the corporation issues stock of $500,000 and its bonds or notes for $250,000, it would qualify as a small business corporation since the payments for bonds or notes do not represent sums received for stock or as contributions to capital. It is unlikely that the Commissioner would attack the arrangement as constituting a "thin capitalization".

In addition to the restriction upon issuance of stock for money or other property in excess of $500,000, the aggregate dollar amount of stock which may be offered plus the equity capital of the corporation cannot exceed $1,000,000. For the purpose of the restriction, the term "equity capital" means the sum of money and other property (in an amount equal to its adjusted basis for determining gain) of the corporation, less the amount of indebtedness to persons other than stockholders. Equity capital would usually be the sum of the book value of the corporation and the aggregate of loans payable to stockholders. However, the term "indebtedness to stockholders" will probably be construed to include unpaid salaries, bonuses, interest, expenses, and dividends payable to stockholders.

Although it has been suggested in this note that consideration should be given to the issuance of bonds or notes in lieu of stock when capital in excess of $500,000 is required, in the more usual situation careful consideration should be given to the problem of whether any debt obligations to stockholders will be issued. Taxpayers are usually aware of the tax ad-

vantages which accrue to the organizers of corporations if they become creditors as well as stockholders of the corporation. Since interest is deductible while dividends are not, there is an obvious tax incentive to having a corporation issue evidences of indebtedness as well as stock for the cash or property transferred to it by its stockholders. Moreover, if the corporation prospers, it may pay off its debt to its creditor-stockholders and, except to the extent that such payments exceed the adjusted basis of the debt instrument, the stockholder will realize no income. To obtain these advantages it was usually considered desirable to have the corporation issue stock and evidences of debt in exchange for cash and property. Care was exercised in making the determination of the amount of stock and debt to be issued to avoid or minimize the challenge by the Commissioner that the corporation was "thinly" capitalized. Even so, many taxpayers have been unsuccessful in their efforts and the Commissioner and the courts have determined that the alleged "loan" should be treated as a disguised capital investment. In the event the corporation was unsuccessful and unable to pay its debts to its stockholders, the loss arising from the debt was usually treated as a short-term capital loss. Section 1244 operates to give an ordinary loss only for loss on stock; the loss on the stockholders' loan remains a capital loss. In view of the favored treatment afforded losses upon stock issued under section 1244 over that of stockholders' debt, it might be preferable to issue stock for all capital supplied to the corporation thereby avoiding entirely the "thin" incorporation problems. Especially would this be true in those situations where the arrangement might fairly be subject to challenge by the Commissioner. The writer is not particularly enchanted with laws which place a premium on tax planning designed for the purpose of making one type of loss more desirable than another type. Unfortunately, however, section 1244 requires such planning.

In addition to being a "small business corporation", the corporation, when the loss was sustained, must not have had

certain investment or so-called "personal holding company income." The rule is that for the five completed taxable years prior to the loss, more than 50 per cent of the corporation's aggregate gross receipts must be from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. In other words, more than 50 per cent of its gross receipts must be from active trade or business sources. If the corporation has not been in existence for five taxable years prior to the loss, the 50 per cent test applies to the period for the taxable year prior to the loss during which the corporation was in existence; and if the loss is sustained during the first taxable year of the corporation such test applies for the period of its existence. However, it should be noted that the 50 per cent gross receipts limitation is not applicable to a corporation whose deductions over the specified period exceeded its gross income.

Qualifying Stock

The qualifying stock must be common stock in a domestic corporation. The common stock may be voting or nonvoting stock. The corporation may have preferred stock but only the common will qualify. The common stock may not be convertible into other securities of the corporation. Securities convertible into common stock are not treated as common stock.

The stock must be issued to the stockholder for money or other property. Stock issued in exchange for stock or securities is not considered as being issued for property. However, if stock is issued in exchange for stock or securities pursuant to a recapitalization or in connection with a change in identity, form, or place of organization of the corporation, the stock will qualify. Common stock issued as a dividend upon qualifying stock is treated as qualifying stock. Stock issued for services rendered or to be rendered is not qualifying stock.

The stock must have been issued under a plan adopted after June 30, 1958, to offer such stock for a period specified in the plan and ending not later than two years after the plan was adopted. Although section 1244 does not specifically provide

that the plan should be in writing, the proposed regulations state that the plan must be a written plan. Letters to stockholders and financial plans filed with stock statements may suffice as a writing but care must be taken to prescribe the period for which such stock must be issued. The proposed regulations provide that the requirements for the period will be met if the period is based upon the date when, under the rules or regulations of a Government agency relating to the issuance of the stock, the stock may lawfully be sold, and it is clear that such period will end, and in fact does end, within two years after the plan is adopted. Presumably, if stock is issued within the two-year period and pursuant to a stock statement duly filed with the State Corporation Commission, the requirements of the plan would be met.

The corporation may adopt as many plans as desired and each plan may qualify for the benefits of section 1244. The corporation may not, however, have two plans in existence at the same time. At the time of the adoption of a plan, a prior offering of stock may not be outstanding as to any of the shares offered thereby and then unsubscribed. If any portion of an offering of common or preferred stock is outstanding at the time of adoption of the plan, stock issued under either plan will not qualify. Any plan adopted should provide that offering under the plan, if not otherwise terminated by the expiration of a stated period of time, should terminate when the corporation shall make a subsequent offering of any stock. The proposed regulations provide that the mere authorization in the articles of incorporation to issue stock in excess of stock offered under the plan is not considered a prior offering.

Stock may qualify although it is subscribed for prior to the adoption of the plan, or even prior to the date the corporation comes into existence, provided the stock is not in fact issued prior to the adoption of the plan.

It is to be expected that the Commissioner will attach great significance to the existence of a written plan. To avoid difficulties with the examining revenue agent, the plan should be

formally adopted by the board of directors of the corporation. The plan should be complete and should specify the period of the offering (which cannot exceed two years). The minutes of the meeting of the board of directors at which the plan is adopted, or the plan itself, should recite that the stock is being offered to qualify it under section 1244. A balance sheet showing the equity capital of the corporation before and after the issuance of the proposal should be attached to the minutes. The proposed regulations provide that the plan must specifically state, in terms of dollars, the maximum amount to be received by the corporation in consideration for the stock to be issued under the plan. Section 1244 does not require specifically that the plan set forth the maximum dollar amount to be received. It provides only that the amount cannot exceed the limits of an offering of $500,000 and equity capital of $1,000,000.

The adoption by the board of directors of a corporation of a resolution as follows would appear to meet the requirements of a plan:

> RESOLVED, that a plan for the issue of 250 shares of common stock, par value $100 a share, of this Corporation is hereby adopted, under which this Corporation will offer for sale 250 shares of such common stock at a price of $100 a share, the maximum amount to be received by this Corporation for such shares being $25,000, such offer to expire at 3 o'clock in the afternoon on the 60th calendar day following the date of this meeting, or at such date when this Corporation shall make a subsequent offering of any stock, whichever shall occur sooner.

The proposed regulations provide that the plan must appear upon the records of the corporation. In addition, in order to substantiate an ordinary loss deduction claimed by its stockholders, the corporation should maintain records showing the following:

(1) The persons to whom stock was issued pursuant to the plan, the date of issuance to each, and a description

of the amount and type of consideration received from each;

(2) If the consideration received is property, the basis in the hands of the shareholder and the fair market value of such property when received by the corporation;

(3) Which certificates represent stock issued pursuant to the plan;

(4) The amount of money and the basis in the hands of the corporation of other property received after June 30, 1958, and before the adoption of the plan for its stock, as a contribution to capital, and as paid-in surplus;

(5) The equity capital of the corporation on the date of adoption of the plan; and

(6) Information relating to any tax-free stock dividend made with respect to stock issued pursuant to the plan and any reorganization in which stock is transferred by the corporation in exchange for stock issued pursuant to the plan.

The proposed regulations also require the stockholders claiming an ordinary deduction to file with his tax return a statement setting forth:

(1) The address of the corporation that issued the stock;

(2) The manner in which the stock was acquired by such person and the nature and amount of the consideration paid; and

(3) If the stock was acquired in a non-taxable transaction in exchange for property other than money—the type of property, its fair market value on the date of transfer to the corporation, and its adjusted basis on such date.

Limitation of Loss

Section 1244 provides a loss limitation of $50,000 per annum in the case of husband and wife filing a joint return, and $25,000 per annum for unmarried taxpayers. The excess of loss, if any, over the limitation is treated as a capital loss. For example, if A, an unmarried individual, sustains a loss upon stock qualifying under section 1244 in the amount of $40,000,

;25,000 of the loss is deductible as an ordinary loss and the ıalance, $15,000, is treated as a capital loss.

The section 1244 loss qualifies as a net operating loss, so hat a loss up to the limitation may be carried backward and 'orward under the rules relating to net operating loss deduc-ions.