

1976

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Recommended Citation

Section 1244 Small Business Stock - Professional Responsibility Demands Its Use, 10 U. Rich. L. Rev. 355 (1976).

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SECTION 1244 SMALL BUSINESS STOCK—PROFESSIONAL RESPONSIBILITY DEMANDS ITS USE

In 1958, Congress added section 1244 to the Internal Revenue Code,¹ which allows ordinary loss treatment for original owners of specified stock in "small business corporations" when such stock is sold, exchanged at a loss, or when the stock becomes worthless.² The purpose of section 1244 is to reduce the discrepancy between the tax treatment of losses sustained by corporations and those sustained by proprietorships or partnerships, thereby diminishing the role which tax considerations play in determining whether a business should be conducted in corporate or in unincorporated form.³ When an unincorporated business sustains an operating loss, such loss is deductible in full against the ordinary income of the owners, with any excess not absorbed by the income of the current year available in other years as a net operating loss carryover or carryback.⁴ Prior to the enactment of section 1244, a loss sustained by a shareholder of a corporation on the sale or exchange of corporate stock or on the date the stock became worthless⁵ was treated as a capital loss, deductible only against capital gain and \$1000 of ordinary income, with a right to carry over any excess to future years.⁶

It should be emphasized that section 1244 only operates to the taxpayer's benefit in situations where an ordinary loss is preferable to a capital loss.⁷ If the technical requirements of the section are satisfied, the shareholder of section 1244 stock may be entitled to an ordinary loss rather than a capital loss when the stock is sold or exchanged at a loss, or when the stock becomes worthless. Failure to satisfy the technical requirements results in the loss being treated as a capital loss, the same result as that obtained in

1. INT. REV. CODE OF 1954, § 1244, added by section 202 of the Small Business Tax Revision Act of 1958, Pub. L. No. 85-866, tit. II, 72 Stat. 1676.

2. INT. REV. CODE OF 1954, § 1244.

3. H.R. REP. NO. 2198, 85th Cong., 1st Sess. 2 (1958), in 1959-2 CUM. BULL. 709, 711.

4. INT. REV. CODE OF 1954, § 172.

5. When stock and securities become worthless, they are treated as having been sold for zero on the last day of the taxable year in which they became worthless. INT. REV. CODE OF 1954, § 165(g).

6. INT. REV. CODE OF 1954, § 1212(b) provides that a net capital loss sustained in any year by an individual may be carried over for an unlimited number of years and deducted in succeeding taxable years until exhausted. "Net capital loss" is the excess of capital losses over capital gains in the taxable year plus up to \$1,000 of ordinary income in the year. *Id.* § 1222(10). Therefore, the capital loss carried over to the current year is reduced by capital gains and taxable income up to \$1,000 in the loss year and in each intervening year. Treas. Reg. § 1.1212-1(a) (1957).

7. McGuffie, 98-2nd T.M., *Small Business Stock* at A-2 [hereinafter cited as 98-2nd T.M.].

the absence of section 1244.⁸ Therefore, the taxpayer has everything to gain and nothing to lose in his attempt to qualify stock under section 1244. Accordingly, the practicing attorney who incorporates a small business without considering the use of section 1244 has not provided his client with the full benefit of his professional services.

TAXPAYERS ENTITLED TO ORDINARY LOSS TREATMENT UNDER SECTION 1244

Under section 1244, the only taxpayer entitled to an ordinary loss deduction is an *individual* issued the stock by the small business corporation or an *individual* who was a partner in a partnership at the time the partnership acquired the stock in an issuance from a small business corporation and whose distributive share reflects the loss sustained by the partnership.⁹ Therefore, losses sustained on stock held by a corporation, estate, or trust will not qualify for ordinary loss treatment under section 1244 regardless of how the stock was acquired.¹⁰ Nor is ordinary loss treatment available to a partner to whom stock is distributed by a partnership.¹¹ Since section 1244 was designed in part to encourage investment of capital in new corporations and in existing corporations with limited capital,¹² its benefits are limited to losses sustained by the original investors, *i. e.*, the individual or partnership which actually invested cash or property in the corporation as opposed to an individual who acquired the stock from a shareholder by purchase, gift, bequest, or any other method.¹³

ANNUAL LIMITATION OF ORDINARY LOSS DEDUCTION

The aggregate amount of ordinary loss allowed a taxpayer in any taxable year under section 1244 is \$25,000, unless the taxpayer is married and files a joint return, in which event the limitation on the aggregate amount of ordinary loss is \$50,000, even though the loss may have been sustained by

8. This nothing-to-lose aspect of section 1244 contrasts with most other tax saving plans, which generally commit the taxpayer to a course of action that may become detrimental if the plan is not carried out successfully.

9. Treas. Reg. § 1.1244(a)-1(b)(1), (2) (1960).

10. *Id.* § 1.1244(a)-1(b).

11. *Id.* Stock acquired through an investment banking firm, or other person, participating in the sale of an issue may qualify for ordinary loss treatment if the stock is not first issued to such firm or person. *Id.* For example, stock may qualify if the investment banking firm acts as a selling agent for the issuing corporation. *Id.*

12. The encouragement is derived from the reduction of the risk of loss for the invested funds, thereby making investment in small corporate businesses more attractive by placing shareholders on a more nearly equal basis with proprietors and partners. H.R. REP. No. 2198, 85th Cong., 1st Sess. (1958), in 1959-2 CUM. BULL. 709, 711.

13. Treas. Reg. § 1.1244(a)-1(b) (1960).

only one spouse.¹⁴ In the case of a partnership, the limitation is determined separately as to each partner by reference to the type of return filed by each partner for the year in which the tax year of the partnership ends.¹⁵ Any amount of loss due to section 1244 stock in excess of the applicable limitation is treated as a capital loss.¹⁶ However, if the ordinary loss is within the annual limitation but exceeds the ordinary income of the taxable year of the loss, the excess is available as a net operating loss carryback or carryover.¹⁷

REQUIREMENTS OF SECTION 1244 STOCK

In order for stock to qualify as "section 1244 stock" the following statutory requirements must be completely satisfied: the stock must be (1) common stock¹⁸ (2) issued by a domestic corporation¹⁹ (3) pursuant to a plan adopted by the corporation after June 30, 1958, to offer the stock during a specified period not exceeding two years from the date the plan is adopted;²⁰ at the time the plan is adopted, (4) the corporation must be a "small business corporation" as defined by section 1244(c)(2)²¹ and (5) there must be no portion of any prior offering of stock outstanding;²² (6) there must be no new offering to issue stock by the corporation subsequent to the adoption of the plan and before the issuance of stock pursuant to the plan;²³ (7) the stock must be issued to the taxpayer in consideration for money or property, not including stock or securities;²⁴ and (8) for the five most recent taxable years ending before the date of loss, the corporation must have derived less than 50% of its gross receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks or securities.²⁵ With one exception, all these requirements must be met at the time the stock is issued.²⁶

14. *Id.* § 1.1244(b)-1.

15. *Id.* For example, if A and B are both married, file joint returns, and are equal partners, then up to \$100,000 of partnership loss on section 1244 stock may be taken as an ordinary loss deduction - \$50,000 by each partner. 98-2nd T.M., *supra* note 7, at A-4, -5.

16. Treas. Reg. § 1.1244(b)-1 (1960).

17. INT. REV. CODE OF 1954, § 1244(d)(3).

18. *Id.* § 1244(c)(1).

19. *Id.*

20. *Id.* § 1244(c)(1)(A), (D).

21. *Id.* § 1244(c)(1)(B).

22. *Id.* § 1244(c)(1)(C).

23. *Id.* § 1244(c)(1)(last sentence).

24. *Id.* § 1244(c)(1)(D).

25. *Id.* § 1244(c)(1)(E).

26. The "gross receipts" test may only be determined to have been satisfied at the time the loss is sustained. Therefore, a shareholder may never be absolutely assured that he will

(1) *Common Stock*—Either voting or non-voting common stock will qualify under section 1244. However, the regulations provide that neither common stock which is convertible into securities of the corporation nor securities of the corporation which are convertible into common stock shall be treated as "common stock" under section 1244.²⁷

(2) *Domestic Corporation*—A domestic corporation is defined in the Internal Revenue Code as a corporation "created or organized in the United States or under the law of the United States or of any State or Territory."²⁸

(3) *Adopted Plan*—For stock to qualify under section 1244, the corporation must adopt a *written*²⁹ plan which specifies that the period of time for which the offer remains open will end no later than two years after the date the plan is adopted.³⁰ In addition, the plan must specifically set forth in terms of dollars the maximum amount to be received by the corporation in consideration for the stock to be issued under such plan.³¹ The plan should be carefully set out in the minutes of a board of directors meeting, preferably in the form of a resolution.³²

receive ordinary loss treatment until the loss is actually sustained and it has been determined that the corporation meets the "gross receipts" test.

27. Treas. Reg. § 1.1244(c)-1(b) (1960).

28. INT. REV. CODE OF 1954, § 7701(a)(4).

29. Although the Code does not specifically require a *written* plan to be adopted, the regulations provide that the plan must be in writing. Treas. Reg. § 1.1244(c)-1(c)(1) (1960). This regulation requirement is supported by the committee report, note 3 *supra*, and its validity and reasonableness have been upheld by the courts. See Bernard Speigel, 49 T.C. 527 (1968); Bruce v. United States, 279 F. Supp. 686 (S.D. Tex. 1967), *aff'd*, 409 F.2d 1317 (5th Cir. 1969); Wesley H. Morgan, 46 T.C. 878 (1966).

30. INT. REV. CODE OF 1954, § 1244(c)(1)(A).

31. Treas. Reg. § 1.1244(c)-1(c)(1) (1960).

32. The following resolution reflects the requirements that must be satisfied in order to qualify stock under section 1244:

WHEREAS, the Board of Directors wishes to offer for sale and issue 400 shares of its common stock authorized by its Certificate of Incorporation; and

WHEREAS, it is further deemed desirable that the offer, sale and issue of such shares be carried out in such a manner that, in the hands of qualified shareholders, such shares will receive the benefits of § 1244 of the Internal Revenue Code of 1954; and

WHEREAS, there is not now outstanding any offering, or portion thereof, of this Corporation to sell or issue any of its stock; and

WHEREAS, this Corporation is a small business corporation as defined in § 1244(c)(2) of the Internal Revenue Code of 1954;

NOW, THEREFORE, BE IT RESOLVED, that the President of this Corporation and such other officers as he may designate be, and hereby are, authorized and directed to offer for sale and to sell and to issue up to 1,000 shares of the common stock in the total amount of \$100,000 at \$100 per share payable in cash or other property (other than stock or securities) during the period from the date hereof to six months hereafter

In order to qualify, the stock must be issued during the period of the offer. Stock subscribed for but not issued during the plan period will not qualify as section 1244 stock.³³ Subscriptions prior to the adoption of the plan, including subscriptions prior to the date on which the business was incorporated, will qualify as long as such stock is issued after the plan is adopted and before the plan expires.³⁴ Stock issued for a payment which, alone or together with prior payments, exceeds the maximum amount that may be received by the corporation as stated in the plan, will not be considered as issued pursuant to the plan and, therefore, will not qualify as section 1244 stock.³⁵

(4) *"Small Business Corporation" Test*—In order for stock to qualify under section 1244, the issuing corporation must be a "small business corporation" as defined by section 1244(c)(2). The small business corporation test has two parts, both of which must be met *at the time the plan is adopted*. The fact that either or both of the parts of the test are not met by the corporation *at the time of the loss* is immaterial. The first part of the test requires that the sum of the aggregate dollar amount to be paid for the stock which may be offered under the plan *plus* the aggregate amount of money and other property which has been received by the corporation (after June 30, 1958) for its stock, as a contribution of capital by its shareholders, and as paid-in surplus must not exceed \$500,000.³⁶ Under this requirement, property is taken into account at its adjusted basis to the corporation as of the date received by the corporation.³⁷ Also, the aggregate amount is reduced by the amount of liabilities which were assumed by the corporation or to which the property was subject at the time of receipt by the corporation.³⁸

For purposes of the \$500,000 test, the total amount of money and other property received for stock, as contribution of capital, and as paid-in surplus is not reduced by corporate distributions to shareholders even though

or to the date when this Corporation shall make a subsequent offering of any stock, whichever shall first occur. 98-2nd T.M., *supra* note 7, at B-20.

The amounts and time restrictions in the sample resolution are arbitrarily chosen and can of course be adjusted to the particular stock issuance.

33. Treas. Reg. § 1.1244(c)-1(c)(2) (1960) provides that stock issued on the exercise of a stock right, stock warrant, or stock option will be treated as issued pursuant to a plan only if such right, warrant, or option: (1) was not outstanding at the time the plan was adopted; (2) is applicable solely to unissued stock offered under the plan; and (3) is exercised during the period of the plan.

34. Treas. Reg. § 1.1244(c)-1(c)(3) (1960).

35. *Id.* § 1.1244(c)-1(c)(4).

36. INT. REV. CODE OF 1954, § 1244(c)(2)(A).

37. Treas. Reg. § 1.1244(c)-2(b)(1) (1960).

38. *Id.*

such distributions are capital distributions.³⁹ Once the total amount received by the corporation, as contribution to capital and as paid-in surplus, reaches \$500,000, the corporation is thereafter precluded from adopting a plan under which section 1244 stock may be issued.⁴⁰

The second part of the small business corporation test requires that the sum of the aggregate dollar amount to be paid for stock which may be offered under the plan *plus* the equity capital of the corporation as of the date of the adoption of the plan must not exceed \$1,000,000.⁴¹ The equity capital of the corporation is considered to be the sum of its money and other property less the amount of the corporation's indebtedness to persons *other than* shareholders.⁴² Again, property is to be considered as an amount equal to its adjusted basis for determining gain.⁴³

(5) *Prior Offerings*—If any portion of a prior offering of stock, whether common or preferred,⁴⁴ remains unissued at the time of the plan's adoption, no stock issued under the current plan will qualify under section 1244.⁴⁵ Therefore, before a plan is adopted pursuant to section 1244, all prior offerings⁴⁶ of stock should be withdrawn by an affirmative action of the board of directors if possible.⁴⁷

(6) *Subsequent Offerings*—As a corollary to the rule prohibiting an existing prior offering, any stock issued pursuant to the section 1244 plan after a subsequent offering is made will not qualify as section 1244 stock.⁴⁸ Stock that is issued under the plan prior to a subsequent offering is not disqualified by such subsequent offering.⁴⁹ Any issuance of stock other than that offered under the plan is considered a subsequent offering.⁵⁰ Also, any modification of the existing plan is considered a subsequent offering if it (1) changes the offer to include preferred stock,⁵¹ or (2) increases the

39. *Id.* § 1.1244(c)-2(b)(2).

40. *Id.*

41. INT. REV. CODE OF 1954, § 1244(c)(2)(B).

42. Treas. Reg. § 1.1244(c)-2(c) (1960).

43. *Id.*

44. *Id.* § 1.1244(c)-1(e).

45. INT. REV. CODE OF 1954, § 1244(c)(1)(C).

46. Stock rights, stock warrants, stock options, and securities convertible into stock, which are outstanding at the time the plan is adopted, are deemed to be prior offerings. Treas. Reg. § 1.1244(c)-1(e) (1960).

47. Outstanding stock rights, stock warrants, stock options or convertible securities present a considerable problem to the corporation since the corporation cannot generally revoke such rights of the holder by unilateral action. For a discussion of this problem see 98-2nd T.M., *supra* note 7, at A-13.

48. Treas. Reg. § 1.1244(c)-1(h)(1) (1960).

49. *Id.*

50. *Id.*

51. *Id.* § 1.1244(c)-1(h)(2).

amount of stock that may be issued thereunder to such an extent that the small business corporation test would not have been satisfied if determined with reference to such amount as of the date the plan was initially adopted,⁵² or (3) extends the period of time during which stock may be issued under the plan to more than two years from the date the plan was initially adopted.⁵³ A corporation may withdraw a plan and adopt a new one which will qualify under section 1244 if the new plan satisfies all the requirements as set forth in that section.⁵⁴

(7) *Issued For Money or Other Property*—Stock will not qualify under section 1244 unless it was issued to a shareholder in consideration for money or other property, not including stock or securities.⁵⁵ Therefore, stock issued in exchange for services rendered or to be rendered to, or on behalf of, the issuing corporation will not qualify.⁵⁶ Stock issued in consideration of cancellation of indebtedness will qualify unless the indebtedness of the corporation to the shareholder is evidenced by a security or arises out of the performance of personal services.⁵⁷

The prohibition against the issuance of stock in consideration for stock or securities is subject to three exceptions. First, if common stock is received by an individual or partnership in a nontaxable stock dividend distribution made solely with respect to stock owned by the individual or partnership which meets the requirements of section 1244 determinable at the time of distribution,⁵⁸ then such common stock will also qualify as section 1244 stock.⁵⁹ A second exception similarly applies to a tax-free

52. *Id.*

53. *Id.*

54. *Id.*

55. INT. REV. CODE OF 1954, § 1244(c)(1)(D).

56. Treas. Reg. § 1.1244(c)-1(f)(1) (1960).

57. *Id.*

58. *Id.* § 1.1244(d)-3(b)(1). For the purposes of this exception, the requirements of section 1244 stock determinable at the time of distribution are all the requirements of section 1244(c)(1) except the gross receipts test.

59. *Id.* § 1.1244(d)-3(b)(1). However, if the stock dividend is received by the individual partly with respect to qualifying stock and partly with respect to non-qualifying stock, then only part of the stock received as a stock dividend will be treated as meeting the requirements of this exception. *Id.* § 1.1244(d)-3(b)(2).

Assuming all qualifying and non-qualifying stock have equal rights to dividends, the part qualifying under this exception is the number of shares which bears the same ratio to the total number of shares received as the number of shares qualifying under section 1244 owned immediately before the stock dividend bears to the total number of shares with respect to which the stock dividend is received. *Id.* The adjustment of basis under section 307 shall apply as if two separate nontaxable stock dividends were made, one with respect to the qualifying stock and the other with respect to the non-qualifying shares. *Id.* The regulations provide the following example to illustrate these principles:

recapitalization⁶⁰ in which common stock is received by the individual or partnership in exchange for stock of the corporation which qualifies under section 1244 immediately prior to the recapitalization.⁶¹ The third exception applies when an individual or partnership receives common stock pursuant to a corporate reorganization described in section 368(a)(1)(F)⁶² in exchange for section 1244 stock of the predecessor corporation.⁶³

In 1959, Corporation Y issues 100 shares of its common stock to C for \$1,000 and these shares meet the requirements of section 1244 determinable at the time of the issuance. In 1960, C purchases an additional 200 shares of such stock from another shareholder for \$3,000; however, these shares do not meet the requirements of section 1244 stock because they were not originally issued to C by the corporation. In 1961, C receives 15 shares of Corporation Y common stock as a stock dividend. Of the shares received, 5 shares, the number received with respect to the 100 shares of stock which met the requirements of section 1244 at the time of the distribution, i.e., 100 X 15, shall also be treated as meeting such requirements. The remaining 10 shares do not meet such requirements as they are not received with respect to section 1244 stock. The basis of such 5 shares is determined by applying section 307 as if the 5 shares were received as a separate stock dividend made solely with respect to shares that meet the requirements of section 1244 stock at the time of the distribution. Thus, the basis of the 5 shares is \$47.61 (105 of \$1,000). Treas. Reg. § 1.1244(d)-3(b)(3) Example (ii) (1960).

60. INT. REV. CODE OF 1954, § 368(a)(1)(E).

61. Treas. Reg. § 1.1244(d)-3(c)(1) (1960). A similar rule to that discussed in note 59 *supra* applies where the taxpayer, prior to the recapitalization, owns stock part of which qualifies under section 1244 and part of which does not. If common stock is received in the recapitalization, only part of such stock will meet the requirements of this exception to the general rule that stock must be issued for money or other property (other than stock or securities). Such part is equal to the number of shares which bears the same ratio to the total number of shares of common stock received as the basis of the qualifying shares transferred bears to the basis of all shares transferred for the surrendered common stock. *Id.* § 1.1244(d)-3(c)(2). The basis of the stock meeting the requirements of this exception is limited to the basis of the stock qualifying under section 1244 transferred in the exchange. *Id.* Again, the example provided in the regulations is helpful to illustrate this rule:

B owns 500 shares of common stock of Corporation X with a basis of \$5,000, and 100 shares of preferred stock of that corporation with a basis of \$2,500. Pursuant to a recapitalization described in section 368(a)(1)(E), B exchanges all of his shares for 900 shares of common stock of Corporation X. The 500 common shares meet the requirements of section 1244 determinable at the time of the exchange, but the 100 preferred shares do not meet such requirements since only common stock may qualify. Of the 900 common shares received, 600 shares ($\frac{\$5,000}{\$7,500} \times 900$ shares) are treated as meeting

the requirements of section 1244 at the time of the exchange, because they are deemed to be received in exchange for the 500 common shares which met such requirements. The remaining 300 shares do not meet such requirements as they are not deemed to be received in exchange for section 1244 stock. The basis of the 600 shares is \$5,000, the basis of the relinquished shares meeting the requirements of section 1244. Treas. Reg. § 1.1244(d)-3(c)(3) Example (ii) (1960).

62. An "F-type" corporate reorganization is defined as "a mere change in identity, form, or place of organization, however effected." INT. REV. CODE OF 1954, § 368(a)(1)(F).

63. Treas. Reg. § 1.1244(d)-3(d)(1) (1960). The problem of receiving common stock par-

It should be noted in reference to the requirement that section 1244 stock be issued in exchange for money or other property, not including stock or securities except as stated above, that disqualification as a result of non-compliance with this requirement is personal to the shareholder who fails to give money or property for section 1244 stock.⁶⁴ Disqualification of one shareholder has no effect on other shareholders who comply with the requirement.

(8) *The Gross Receipts Test*—Compliance with all requirements of section 1244 except one can be determined at the time the stock is issued. The gross receipts test, however, can only be determined to have been met at the time the loss is sustained, *i.e.*, when the stock is sold or exchanged at a loss or when it becomes worthless. The gross receipts test provides that the stock will not qualify under section 1244 unless more than 50% of the aggregate gross receipts of the corporation are from sources other than royalties, rents, dividends, interest, annuities, and sales of stocks and securities for the five most recent years ending before the date of the loss.⁶⁵ If the corporation has not been in existence for five years prior to the date of the loss on the stock, the measuring period is the completed taxable years prior to the year of loss, unless the corporation has not been in existence for a full year, in which case, the measuring period is that portion of the year during which the corporation was in existence.⁶⁶

The term “gross receipts” as used in section 1244 means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income, including the total amount of receipts not reduced by returns and allowances, costs, or deductions.⁶⁷ The term includes the total amount received or accrued by the corporation from the sale or exchange of any type of property, from investments, and from any services rendered by the corporation.⁶⁸ Amounts received as a loan, as repayment of a loan, as a contribution to capital, or on the issuance of the corporation’s own stock will not be considered as gross receipts.⁶⁹ The 50% requirement need not be satisfied if the aggregate amount of deductions allowed the corporation exceeds the aggregate

tially in exchange for qualifying stock and partially in exchange for non-qualifying stock is treated in the identical manner described in note 61 *supra*.

64. 98-2nd T.M., *supra* note 7, at A-16.

65. INT. REV. CODE OF 1954, § 1244(c)(1)(E).

66. Treas. Reg. § 1.1244(c)-1(g)(1)(i)(a) (1960).

67. *Id.*

68. *Id.*

69. *Id.* Gross receipts do not include amounts received in nontaxable sales or exchanges (other than those to which section 337 applies), except to the extent of gains recognized by the corporation. *Id.*

amount of the corporation's gross income for the applicable period.⁷⁰

SPECIFIC PROBLEM AREAS

A. Increase In The Basis of Section 1244 Stock—Any increase in the basis of section 1244 stock is treated as allocable to stock which is not section 1244 stock.⁷¹ Therefore, if subsequent to the issuance of section 1244 stock a contribution to capital is made thereby increasing the stock's basis, the increase in the basis may not be used for the purpose of section 1244. A loss on stock, the basis of which has been increased subsequent to its issuance, according to the regulations, is to be apportioned between that part which qualifies as section 1244 stock and the part that does not so qualify.⁷² The formula for determining the amount of loss apportioned to the part which does qualify is that amount of loss which bears the same ratio to the total loss as the basis of the stock which is treated as allocated to section 1244 stock bears to the total basis of the stock.⁷³

B. Contributions of Property Having A Basis in Excess of Value—Section 1244(d)(1)(A) sets forth a special rule which limits ordinary loss treatment in the situation where section 1244 stock is issued by a corporation in exchange for property that has an adjusted basis, immediately before the exchange, in excess of its fair market value. The rule provides that when such property is exchanged for section 1244 stock under a section 351 nontaxable transaction, then for the purposes of section 1244 alone,⁷⁴ the basis of such stock is reduced by an amount equal to the excess, at the time of the exchange, of the adjusted basis of the property over its fair market value.⁷⁵ However, it should be emphasized that this rule does not affect the basis of the stock for any purposes other than section 1244, nor does it affect the amount of loss. This rule prevents section 1244 from being used purely as a means of converting a capital loss into an ordinary

70. Deductions allowed by section 172, relating to the net operating loss deduction, and by sections 242, 243, 244, and 245 (relating to special deductions for corporations) cannot be taken into account under this exception. Treas. Reg. § 1.1244(c)-1(g)(2) (1960).

71. Treas. Reg. § 1.1244(d)-2(a) (1960). This rule applies to any increase in the basis of section 1244 stock, however effected.

72. *Id.*

73. The regulations provide an example in order to illustrate this rule: A corporation issues 100 shares of section 1244 stock to X for \$10,000. X later contributes \$2,000 to the capital of the corporation, increasing his total basis of his 100 shares to \$12,000. Subsequently, he sells his 100 shares for \$9,000. Of the \$3,000 loss, \$2,500 is treated as an ordinary loss deduction ($\frac{\$10,000}{\$12,000}$ of \$3,000), and the remaining \$500 must be treated as a capital loss. Treas. Reg. § 1.1244(d)-2(b) (1960).

74. *Id.* § 1.1244(d)-1(a)(2).

75. *Id.* § 1.1244(d)-1(a).

loss.⁷⁶ When transfers of several items of property are made in exchange for stock in a single transaction so that the basis of the property is allocated evenly among the shares of stock, the computation for purposes of section 1244 is made by reference to the aggregate fair market value and the aggregate basis of the property transferred.⁷⁷

C. Record Keeping and Information Requirements—In addition to the technical requirements set forth in the Code, the regulations provide additional requirements with respect to record keeping and information requirements.⁷⁸ These requirements are designed to substantiate any ordinary loss deductions claimed by a corporation's shareholders as a result of loss on section 1244 stock.⁷⁹ Proper record keeping is an important factor

76. 98-2nd T.M., *supra* note 7, at A-23. The portfolio offers the following example to illustrate the purpose of this rule:

An individual owns a capital asset with the basis of \$10,000 and a value of \$6,000. If the asset were sold directly the individual would recognize a \$4,000 capital loss. However, if he transfers the property to a corporation, in a § 351 transaction, in exchange for stock qualifying under § 1244, the basis of the stock received would be \$10,000 and presumably its value would be \$6,000. He could then turn around and sell the stock for \$6,000 and, absent any special provisions, obtain ordinary loss treatment on the sale. *Id.* at A-23, -24.

77. Treas. Reg. § 1.1244(d)-1(b) (1960). The regulations illustrate this rule with the following example:

C transfers business assets to a corporation for 100 shares of section 1244 stock in an exchange that qualifies under section 351. The assets transferred are as follows:

	<u>Basis</u>	<u>Fair Market Value</u>
Cash	\$10,000	\$10,000
Inventory	15,000	30,000
Depreciable property	50,000	20,000
Land	<u>25,000</u>	<u>10,000</u>
	\$100,000	\$70,000

The basis for the shares received by C is \$100,000, which is applied \$1,000 to each share. However, the basis of the shares for purposes of section 1244 is \$70,000 (\$700 per share), the basis for general purposes reduced by \$30,000, the excess of the aggregate adjusted basis of the property transferred over the aggregate fair market value of such property. *Id.* § 1.1244(d)-(c) Example (iii).

78. *Id.* § 1.1244(e)-1.

79. The corporation is required to 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,

in the successful election of section 1244.

CONCLUSION

Since no penalty or detriment can result from a section 1244 election, every practicing attorney should feel compelled by professional responsibility to use section 1244 stock as a matter of course when incorporating a new or existing small business and also when capital is to be added to existing small business corporations. Once the attorney is familiar with the statutory framework of the section, a routine use of section 1244 stock would require minimal time, and may potentially result in a substantial benefit for the client should the business enterprise prove unsuccessful.

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as a contribution to capital, and as paid-in surplus;

(5) The equity capital of the corporation on the date of the 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. *Id.* § 1.1244(e)-1(a).

When claiming an ordinary loss deduction due to section 1244 stock, the taxpayer must attach a statement to his tax return 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 nontaxable 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. *Id.* § 1.1244(e)-1(b).

The taxpayer should also maintain records sufficient to distinguish section 1244 stock from any other stock he may own in the corporation. *Id.*