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LEGISLATION

ORDINARY LOSS TREATMENT FOR SECTION 1244 STOCK IN SMALL BUSINESS CORPORATIONS

Introduction

For the first time since 1954, Congress has made a major revision of the tax law.[1] On September 2, 1958, President Eisenhower approved Public Law 85-866.[2] This law includes the Technical Amendments Act and the Small Business Tax Revision Act of 1958.[3] The latter has for its purpose the aiding and encouraging of small business by means of tax relief.[4] As a result of this congressional policy, a budgetary loss of approximately 250,000,000 dollars is expected in the first full year of operation.[5]

A principal goal of the Small Business Tax Revision Act of 1958 is to increase the volume of external financing in small businesses.[6] Section 2 of this act is the means by which this goal is to be achieved.[7] It provides for ordinary loss, rather than capital loss treatment for common stock investments in small business corporations which prove to be unsuccessful.[8] By thus reducing the risk element involved in financing and investing, it is hoped that outside funds will more readily be placed at the disposal of small businesses.[9]

Section 2(b) of the Small Business Tax Revision Act of 1958 adds the new section 1244 to the Internal Revenue Code of 1954.[10]

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1 P-H CONCISE EXPLANATION OF THE NEW 1958 TAX LAW 5 (1958).

2 72 STAT. 1606 (1958).

3 H.R. 13382 (Small Business Tax Revision Act) was an amendment to H.R. 8381 (Technical Amendments Act). See 104 CONG. REC. 15791 (daily ed. Aug. 12, 1958).

4 104 CONG. REC. 15791 (daily ed. Aug. 12, 1958).

5 *Ibid.*

6 *Ibid.* Although outside financing may be a principal goal of the statute, many benefits will accrue to taxpayers who already own stock in a corporation and who wish to invest additional funds.

7 Section 2(b) of the Small Business Tax Revision Act adds § 1244 to the Internal Revenue Code of 1954 although the committee report refers to § 1244 as § 1242. Section 2(a) amends § 165(h) of the Code. See CCH STANDARD FEDERAL TAX REPORT No. 39, p. VII (Sept. 4, 1958) which includes excerpts of the House Ways and Means Committee report on H.R. 13882.

8 104 CONG. REC. 15791 (daily ed. Aug. 12, 1958). However, the statute provides for a maximum limitation. *Ibid.*

9 104 CONG. REC. 15791 (daily ed. Aug. 12, 1958).

10 See CCH STANDARD FEDERAL TAX REPORT No. 39, p. VII (Sept. 4, 1958) which includes excerpts of the House Ways and Means Committee report on H.R. 13882.

Prior to section 1244, a loss from the sale, exchange[11] or worthlessness[12] of stock was treated as a capital loss under section 1221 of the Code.[13] As a capital loss, certain limitations are imposed upon its utility.[14] Section 1211(a) states that in the hands of a corporation, capital losses may only be deducted to the extent of its capital gains.[15] In the hands of taxpayer other than a corporation, capital losses are allowed only to the extent of capital gains, plus the taxable income of the taxpayer or 1,000 dollars, whichever is smaller.[16] However, with the advent of section 1244, it will be possible to obtain ordinary loss treatment on all section 1244 stock.

Section 1244 Stock

Section 1244 allows ordinary loss treatment for a loss of up to 25,000 dollars a year per individual or partnership, or 50,000 dollars a year in the case of a husband and wife filing a joint return, where the original holder of small business stock realizes a loss.[17] To qualify, the stock must be issued subsequent to June 30, 1958,[18] and the sum total of such stock issued may not exceed 500,000 dollars per corporation.[19] Another requirement is that this stock may not increase the equity capital of the corporation to more than 1,000,000 dollars.[20] Only common stock in a domestic corporation may qualify.[21]

Section 1244 stock must be issued pursuant to a corporate plan.[22] While the statute is silent as to the form of such a plan, the report of the House Ways and Means Committee specifies that such plan must be in writing.[23] At present, why any plan is required as a condition precedent to issuing 1244 stock, and what the form and content of such a plan will be, are not apparent.

At the time that the plan is adopted a corporation may not have derived more than fifty per cent of its past aggregate gross receipts from investment income based on the preceding five-year period or

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11 INT. REV. CODE OF 1954, § 165(f).

12 INT. REV. CODE OF 1954, § 165(g)(1)(2).

13 INT. REV. CODE OF 1954, § 1221. An exception exists which refers to dealers in securities. INT. REV. CODE OF 1954, § 1236.

14 INT. REV. CODE OF 1954, § 1211.

15 INT. REV. CODE OF 1954, § 1211(a). A five year carryover of net capital losses is allowed in INT. REV. CODE OF 1954, § 1212.

16 INT. REV. CODE OF 1954, § 1211(b). A five year carryover of net capital losses is allowed in INT. REV. CODE OF 1954, § 1212.

17 INT. REV. CODE OF 1954, § 1244(a)(b). These ordinary loss provisions, therefore, do not apply to corporation, trusts or estates.

18 INT. REV. CODE OF 1954, § 1244(c)(1)(A) is herein applicable.

19 INT. REV. CODE OF 1954, § 1244(c)(2)(A) is herein applicable.

20 INT. REV. CODE OF 1954, § 1244(c)(2)(B) is herein applicable.

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

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

23 See CCH STANDARD FEDERAL TAX REPORT No. 37, p. VIII (Sept. 4, 1958) where excerpts of the House Ways and Means Committee report on H.R. 13882 may be found.

the period since incorporation, whichever is less.[24] A *prior* measuring rod is thus established for determining a corporation's qualification as a small business corporation under section 1244.[25] This presents two problems. First, there is no minimal requirement in time for which this prior measuring rod must exist.[26] This may result in a newly formed corporation being able to meet this requirement by nominally functioning as an operating corporation for a week, or any shorter period of time that the corporation is in existence and has gross receipts. Then, since the week's gross receipts will allow the corporation to qualify, a plan may be adopted to issue 1244 stock and the corporation is free to begin deriving a majority of its income from investments. This is especially significant since the stockholders have two years within which to accept the corporate offer of 1244 stock.[27] The statute explicitly states that the corporation need only qualify as a small business corporation at the time the plan is adopted.[28] The status of the corporation at the time the stock is issued by the corporation is irrelevant. As a result, it is conceivable that the fifty per cent requirement may become a mere formality for newly incorporated businesses which, once a plan is adopted, may then violate both the maximum capital requirement and the nature of gross receipts requirement with impunity and yet be able to issue 1244 stock to their stockholders. It is doubtful whether such a situation will be tolerated by the courts.[29] However, it remains a problem presented by the loose drafting of new section 1244.

A second problem arises because adjusted basis is not included in determining gross receipts on sales of stock or securities, but is included with regard to other assets.[30] Accordingly, by selling property other than stock or securities, a certain amount of investment income will be nullified since the return of capital (the amount of the adjusted basis of the property) will be included in the gross receipts of the corporation.[31]

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[24] The Code refers to ". . . royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities . . . ." See Int. Rev. Code of 1954, § 1244(c)(1)(E). For purposes of this article, these items will be referred to as investment income.

[25] Int. Rev. Code of 1954, § 1244(c)(1)(E).

[26] See Int. Rev. Code of 1954, § 1244(c)(1)(E) wherein a five year maximum limitation, but no minimum requirement, is set forth.

[27] Int. Rev. Code of 1954, § 1244(c)(1)(A).

[28] Int. Rev. Code of 1954, § 1244(c)(1)(B).

[29] A business purpose test may be applied by the courts to expose pure tax avoidance, as in Commissioner v. Roberts, 203 F.2d 304 (4th Cir. 1953).

[30] This problem is also found in relation to Int. Rev. Code of 1954, § 1244(c)(1)(E).

[31] For example, within a particular taxable year a corporation sells stock with an adjusted basis of $5,000 for $14,000. It has thus realized $9,000 of investment income. By selling property which qualifies as a capital asset under § 1231 with an adjusted basis of $5,000 for $10,000, the corporation has earned an additional $5,000 of non-investment income and has successfully offset

Effects of 1244 Stock on Current Practices

A. Thin Incorporation

Thin incorporation has been the subject of an expanding volume of tax litigation.[32] Thin incorporation involves the practice of creating a corporation the major portion of the operating capital of which is supplied by debt financing.[33] The favorable tax consequences from such an arrangement are obvious. The payment of interest on the loans is a deductible business expense to the corporation,[34] whereas a dividend payment represents a distribution of corporate earnings and profits and is not deductible.[35] Furthermore, when the corporation retires its obligations, the investor is permitted to recover his money from the corporation tax-free as a return of capital,[36] avoiding the unnecessary complications and possible dividend treatment of a redemption of stock.[37]

However, it is also obvious that the risk inherent in thin incorporation is that the corporate indebtedness may be treated as equity capital by the Internal Revenue Service.[38] The likelihood of such treatment is very possible,[39] and the consequences are apt to be disadvantageous.[40] There are no statutory aids in this area and the

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the prior investment income for Section 1244 purposes. If the adjusted basis of property other than stock or security were accounted for by Section 1244, this corporation would not qualify since it would not meet the 50% requirement. It would have gross receipts of $14,000 ($9,000 gain from stock plus $5,000 gain from 1231 property) and investment income of $9,000. However, under the present wording of the statute, the annual gross receipts of the corporation amounts to $19,000 since the $5,000 adjusted basis of the 1231 property is included as part of the gross receipts and the corporation thus qualifies ($19,000 gross receipts—$9,000 investment income).

32 See Schlesinger, *Accepted Capital Structures: How Thin Is Too Thin?*, 5 U. Fla. L. Rev. 355 (1952); Spanbeck, Carro & Katz, *Nourishing the Thin Corporation*, 34 Taxes 687 (1956).

33 See Weyher & Weithorn, *Capital Structure of New Corporations*, N.Y.U. 16th Inst. on Fed. Tax. 277, 287 (1958).

34 Int. Rev. Code of 1954, § 163(a).

35 See Weyher & Weithorn, *supra* note 33, at 287.

36 See Surrey & Warren, Federal Income Taxation 118, 1004 (1955 ed.).

37 See Wilson, *Stock Redemptions as Dividends*, 32 Taxes 718 (1954).

38 See Weyher & Weithorn, *Capital Structure of New Corporations*, N.Y.U. 16th Inst. on Fed. Tax. 277, 287 (1958). See also Gregg Co. v. Commissioner, 23 T.C. 170 (1954), *aff'd*, 239 F.2d 498 (2d Cir. 1956); 1432 Broadway Corp. v. Commissioner, 4 T.C. 1158 (1945), *aff'd per curiam*, 160 F.2d 885 (2d Cir. 1947); Janeway v. Commissioner, 2 T.C. 197 (1943), *aff'd*, 147 F.2d 602 (2d Cir. 1945).

39 See Dobkin v. Commissioner, 15 T.C. 31 (1950), *aff'd per curiam*, 192 F.2d 392 (2d Cir. 1951); Sogg v. Commissioner, 19 P-H Tax Ct. Mem. 837 (1950), *aff'd per curiam*, 194 F.2d 540 (6th Cir. 1952).

40 See Weyher & Weithorn, *supra* note 38, at 287-88, where five undesirable consequences are listed. Two disadvantages which would not arise had the taxpayer originally invested in stock rather than debt are:

"(4) Where the corporation has retained earnings for the purpose of eventual courts have consistently repeated that each case must be treated individually.[41] Such devices as the ratio test,[42] the business purpose test[43] and the true intent test[44] have been inconsistently applied to thin incorporation problems.[45]

The classification of debt as equity capital may now add the risk of failing to qualify for ordinary loss treatment to the primary disadvantage of receiving unexpected dividends.[46] Such classification raises the basis of non-1244 stock held by the taxpayer and may result in a subsequent capital loss.[47] This is a factor to be considered before choosing to finance with debt contributions rather than 1244 stock.[48] Another advantage flowing from the use of 1244 stock is that one may now finance a corporation at what is considered a safe ratio at less disadvantage than in the past.[49]

B. Promoter Area

The promoter area is involved when money is loaned to a corporation and the debt is not represented by securities[50] as defined in

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debt repayment, the assessment of a penalty tax with respect to such earnings as having been accumulated beyond the reasonable needs of the business; and (5) Where the indebtedness resulted principally from a profitable sale of assets by a stockholder to the new corporation, the lowering of the depreciable basis of such assets to their original tax cost in the hands of the stockholder-transferor (since classification of indebtedness as equity might recast the transfer as part of a tax-free Section 351 incorporation)." *Ibid.*

[41] See Weyher & Weithorn, *supra* note 38, at 288.

[42] Cases employing the ratio test are Warren H. Brown, 27 T.C. 27, 33 (1956); Dobkin v. Commissioner, *supra* note 39; Sogg v. Commissioner, *supra* note 39. *But see* Sun Properties Inc. v. United States, 220 F.2d 171, 173-74 (5th Cir. 1955); Rowan v. United States, 219 F.2d 51, 55 (5th Cir. 1955), wherein the Fifth Circuit objects to the use of the ratio test.

[43] Cases exhibiting the business purpose test are Earle v. W. J. Jones & Son, Inc., 200 F.2d 846 (9th Cir. 1952); Emmanuel N. Kolkey, 27 T.C. 37, 59 (1956).

[44] The true intent test is exemplified by Miller v. Commissioner, 239 F.2d 729 (9th Cir. 1956) wherein the intent to establish a true debtor-creditor relationship existed. See also Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir.), *cert. denied,* 352 U.S. 1031 (1956).

[45] Comment, *The Thin Incorporation Problem: Are the Courts Fighting the Tar Baby?,* 5 U.C.L.A.L. Rev. 275, 279 (1958).

[46] See note 39 *supra.*

[47] Even if the other stock is 1244 stock, no ordinary loss will result since any contribution to capital will be treated as allocable to non-1244 stock. Int. Rev. Code of 1954, § 1244(d)(1)(B).

[48] If a debt contribution is classified as equity capital, any subsequent loss will result from a stock transaction. But only with 1244 stock will it be an ordinary loss. See Int. Rev. Code of 1954, § 1244(a).

[49] For a discussion of what is a safe ratio, see Weyher & Weithorn, *Capital Structure of New Corporations,* N.Y.U. 16th Inst. of Fed. Tax. 277, 292-93 (1958).

[50] See Surrey & Warren, Federal Income Taxation 1143 (1955 ed.). In setting forth the three areas of investment losses, the third situation is ". . . business bad debts not represented by securities, i.e. the loans of the

section 165(g).[51] If the taxpayer-creditor is in the business of lending money to a number of enterprises and also actively participates in their operation,[52] he may be considered a promoter and any loss on the loans will be deductible in full to him as a business bad debt.[53] The antithesis of promoter classification is that of the mere investor [54] whose loss on the loans is subject to capital loss treatment as a non-business bad debt.[55] In many cases the line drawn between the promoter and the mere investor is extremely narrow.[56]

Taxpayers can now avoid the problem of whether they qualify as promoters by financing with 1244 stock and insuring ordinary loss treatment. It should again be emphasized that this type of stock investment is more prudent where the venture is of a risky nature.[57] Of course where the primary intention of the promoter or mere investor is to purchase stock rather than to effect a loan, it is absolute folly not to qualify the stock under section 1244.

Prior to the enactment of section 1244, a query arose as to whether there was "a valid policy reason for favoring the promoter as against the investor in stocks or securities or in loans not represented by 'securities.'" [58] Presently, the mere investor enjoys equality in loss treatment with the promoter if 1244 stock is utilized. Whereas the promoter is allowed a business bad debt (ordinary loss) on his worthless loans,[59] a mere investor is allowed ordinary loss treatment on his 1244 stock.

C. Guaranteeing of Corporate Loans

In the past, a stockholder wishing to augment corporate funds attempted to circumvent non-business bad debt treatment by not lending money directly to the corporation, but rather having the corporation borrow from a third party and then guaranteeing the corporate loan.[60] Any subsequent loss to the taxpayer on the guarantee might

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'promoter,' result in ordinary losses allowable in full against ordinary income or capital gain, and included in the net operating loss carryback and carryover." *Ibid.*

[51] INT. REV. CODE OF 1954, § 165(g).

[52] These two exigencies for classification as a promoter are found in SURREY & WARREN, FEDERAL INCOME TAXATION 1145 (1955 ed.).

[53] INT. REV. CODE OF 1954, § 166(a).

[54] See SURREY & WARREN, FEDERAL INCOME TAXATION 1145 (1955 ed.).

[55] INT. REV. CODE OF 1954, § 166(d).

[56] See SURREY & WARREN, FEDERAL INCOME TAXATION 1144-45 (1955 ed.) and cases cited therein.

[57] The advantages of debt financing should be recalled, *i.e.*, corporate deductions of interest payments, and getting money out of the corporation tax-free when the debt is retired. See text accompanying notes 34 & 36 *supra*.

[58] SURREY & WARREN, FEDERAL INCOME TAXATION 1143 (1955 ed.).

[59] INT. REV. CODE OF 1954, § 166(a).

[60] Cudlip v. Commissioner, 220 F.2d 565 (6th Cir. 1955); Edwards v. Allen, 216 F.2d 794 (5th Cir. 1954); Pollak v. Commissioner, 209 F.2d 57 (3d Cir. 1954).

be deemed as stemming from a transaction entered into for profit, and therefore an ordinary loss.[61] However, the recent United States Supreme Court case of *Putnam v. Commissioner* [62] has settled the law in this area by holding such losses on guarantees to be non-business bad debts deductible only as capital losses.[63] The illogical inconsistency whereby a creditor received a capital loss and a guarantor-creditor an ordinary loss has thus been abolished.[64]

Unless the taxpayer is able to qualify as a promoter, he is now faced with capital loss treatment on any investment loan. It will behoove a taxpayer to consider the purchase of 1244 stock when he desires to inject new money into a corporation. This is one method by which he can alleviate the effect of the expansion of non-business bad debt treatment into the area of guarantees of corporate loans. Section 1244 now allows the taxpayer to achieve the same result which the *Putnam* case disallowed when he guaranteed corporate loans.

Conclusion

If it is possible for a potential stock-purchaser to acquire 1244 stock rather than non-1244 stock he should by all means do so. No unfavorable consequences accrue to him and, on the contrary, he may be able to obtain future tax benefits. For example, a small corporation which is highly successful issues 1244 stock to enable it to pursue a new venture. Should the new venture result in a loss, the stockholder may be able to realize an ordinary loss on the subsequent sale of the 1244 stock even though he has an over-all unrealized capital gain on his entire business investment.[65]

Section 1244 can also be utilized in the ordinary buy-sell arrangement in closed corporations. Since the ordinary loss rules apply solely to the original purchaser of the stock,[66] it would be preferable not to buy stock from an existing shareholder. If possible, it would

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[61] INT. REV. CODE OF 1954, § 165(c)(2).

[62] 352 U.S. 82 (1956).

[63] *Ibid.*

[64] The inconsistency is pointed out in SURREY & WARREN, FEDERAL INCOME TAXATION 1146 (1955 ed.).

[65] RIA, Tax Coord. 4 (Sept. 18, 1958). "Mr. Jones organized Jones Corporation in 1930 with $25,000 capital. It now has a net worth of $250,000. But the firm is going into a new field which requires an extra $50,000 of capital. Mr. Jones buys $50,000 Jones Corporation stock which is properly handled so as to qualify for ordinary loss.

"The new venture proves unsuccessful and Jones Corporation loses $50,000. The 1/6 interest for which Jones paid $50,000 is now worth only $41,666. If Jones should sell the stock for $41,666, his $8,334 loss on these shares would be fully deductible as an ordinary loss on his return even though he has an unrealized capital gain on the rest of his shares." *Ibid.*

[66] INT. REV. CODE OF 1954, § 1244(a); 104 CONG. REC. 15791 (daily ed. Aug. 12, 1958).

be wise to utilize the corporate entity by having the stockholder sell his stock to the corporation and then buy stock that qualifies under section 1244 directly from the corporation.

A stockholder in a family corporation may be able to establish an ordinary loss on 1244 stock and still keep the stock within the family by selling to in-laws.[67] Needless to say, the sale must be bona fide.

In view of the benefits of section 1244 and other provisions of the Technical Amendments Act of 1958,[68] it would appear that the future trend in small business organization should be and will be towards conducting business in the corporate form.

Recent Changes in Federal Jurisdiction

Introduction

Congress has recently passed an Act amending the statutory provisions in regard to jurisdiction of the federal courts. The amount in controversy in "federal question" and "diversity of citizenship" cases has been increased,[1] and for purposes of diversity jurisdiction corporations are now deemed "citizens" both of their state of incorporation and of the state in which they have their "principal place of business." [2] Also, workmen's compensation cases arising under

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[67] IBP, Tax Planning § 2, at 5 (Aug. 27, 1958).

[68] For example, corporations may now elect more beneficial tax treatment under INT. REV. CODE OF 1954, subchapter S, §§ 1371-77.

[1] Passed July 25, 1958, this amendment provides for four significant changes in diversity jurisdiction provisions. The first stipulates that the "amount in controversy" in diversity cases be in excess of $10,000, exclusive of interest and costs. Formerly, the amount was in excess of $3,000, exclusive of interest and costs. This provision of the amendment is reinforced by the further provision that, if the plaintiff be adjudged entitled to recover less than $10,000, without regard to any counterclaim, the district court may, in its discretion, deny costs to him or even, in addition, impose costs upon him. 72 STAT. 415 (1958), amending 62 STAT. 930 (1948), 28 U.S.C. §§ 1331-32 (1952). The amendment raises the amount in controversy in "federal question" cases to in excess of $10,000 exclusive of interest and costs, but this provision is regarded by Congress as relatively minor. See S. REP. No. 1830, 85th Cong., 2d Sess. 6 (1958): "While this bill applies the $10,000 minimum limitation to cases involving Federal questions, its effect will be greater on diversity cases since many of the so-called Federal question cases will be exempt from its provision. This is for the reason that Federal courts are expressly given original jurisdiction without limitation as to the amount claimed in a great many areas of Federal Law. For example, regardless of the amount claimed, the Federal courts have jurisdiction in copyright, patent, and trademark cases."

[2] 72 STAT. 415 (1958), amending 62 STAT. 930 (1948), 28 U.S.C. §§ 1331-32 (1952).