

CaseStudy

CLAIMING ORDINARY LOSSES FOR SEC. 1244 STOCK



SEC. 1244 ENCOURAGES NEW INVESTMENT in small business by permitting investors to claim an ordinary (rather than a capital) loss on the disposition (including worthlessness) of qualifying small business stock. As an added benefit, any loss that qualifies as an ordinary loss under Sec. 1244 is also treated as a trade or business loss in computing an individual's net operating loss (NOL). Thus, Sec. 1244 losses are allowed for NOL purposes without being limited by nonbusiness income.

An annual limitation is imposed on the amount of Sec. 1244 ordinary loss that is deductible. The maximum deductible loss is \$50,000 per year (\$100,000 if a joint return is filed) (Sec. 1244(b)). Any loss in excess of the limit is a capital loss, subject to the capital loss rules. Thus, if the potential loss exceeds the \$50,000 (or \$100,000) limit, the stock should be disposed of in more than one year to maximize the ordinary loss treatment.

Example 1: In 1998, M contributed \$150,000 cash to his corporation, N Co., in exchange for stock. The business never attained the success M originally envisioned. In 2008, M sold his stock

to an unrelated party for \$40,000. M's tax loss on his sale of stock is \$110,000 (\$40,000 proceeds – \$150,000 stock basis). The stock qualified as Sec. 1244 stock. M files a joint return with his wife, L.

In the year of sale, M can claim a \$100,000 ordinary (Sec. 1244) loss deduction and a \$10,000 capital loss. If M has no 2008 capital gains, his capital loss is limited to \$3,000 (with the balance carried forward), but his ordinary deduction is allowed in full in 2008, assuming he has adequate taxable income.

Example 2: Now assume instead that M sells 90% of his N stock in 2008 for \$36,000 and the remaining 10% in early 2009 for \$4,000. M's tax loss on his 2008 stock sale is \$99,000 [\$36,000 proceeds – (\$150,000 stock basis × 90%)]. M's tax loss on his 2009 stock sale is \$11,000 [\$4,000 proceeds – (\$150,000 – \$135,000)]. By structuring the sale of stock over two years, M is able to avoid the \$100,000 annual limitation on Sec. 1244 losses. Therefore, M can claim a \$110,000 (\$99,000 in 2008 + \$11,000 in 2009) ordinary (Sec. 1244) loss deduction and avoid a capital loss on the stock sale.

Practitioners should attempt to structure a corporation so that the stock qualifies for Sec. 1244 treatment. No election is necessary. There is no penalty for failing to qualify stock for Sec. 1244 treatment. The only result of failure is that the stock

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is treated the same as it would be if no attempt had been made. In many cases, no special planning is needed. Many small corporations will qualify for Sec. 1244 treatment because of the nature and size of their business. Practitioners should also be alert for sales of stock that may qualify for Sec. 1244 loss treatment. This is particularly true for sales of closely held or other nonpublicly traded stock.

Meeting the Sec. 1244 Requirements

For stock to be considered Sec. 1244 stock, the following requirements must be met as of the date of issuance.

First, the corporation must be a small business corporation. A domestic corporation (including an S corporation) is a small business corporation if, when the stock is issued, the total amount of money and property received by the corporation for stock (or as a contribution to capital or as paid in surplus) does not exceed \$1 million (Secs. 1244(c)(1)(A) and (3)(A)). This determination is made each time stock is issued and includes the amount received by the corporation when issuing that specific stock. In the year the \$1 million threshold is exceeded, the corporation may designate the shares to be treated as Sec. 1244 stock. If the corporation does not make a designation, the remaining Sec. 1244 benefit is allocated among all shares issued that year (Regs. Sec. 1.1244(c)-2(b)).

Observation: For contributions of property other than money, the amount considered when computing a Sec. 1244 loss is the property's adjusted basis reduced by liabilities to which the property is subject or that the corporation assumed. However, if the property's fair market value (FMV) is less than its adjusted basis when it is transferred to the corporation, any Sec. 1244 (ordinary) loss is limited to the property's FMV at that transfer date (Sec. 1244(d)(1)(A); Regs. Sec. 1.1244(d)-1).

Second, the stock must be issued in exchange for cash or other property (other than stock and securities) (Sec. 1244(c)(1)(B)). Thus, stock issued in exchange for services does not qualify (Regs. Sec. 1.1244(c)-1(d)(1)). (If possible, the

corporation should pay shareholders in cash for services rendered and then permit them to buy the stock, if desired.) Stock issued in exchange for stock or securities, including stock of the issuing corporation, normally does not qualify for Sec. 1244 treatment. However, stock received in (1) certain stock dividend transactions, (2) an E reorganization (a recapitalization) under Sec. 368(a)(1)(E), or (3) an F reorganization (a change in identity, form, or place of organization) under Sec. 368(a)(1)(F) can qualify.

Cancellation of a bona fide debt in exchange for stock qualifies for Sec. 1244 treatment, unless the debt is evidenced by a security or arises out of the performance of personal services (Regs. Sec. 1.1244(c)-1(d)(1)). However, stock exchanged for debt that is worthless when exchanged will not generate a Sec. 1244 loss because the basis of the stock will be zero. To prevent this, debt should be converted into stock as early in the corporation's life as possible. Waiting to convert until the company reaches a hardship stage (i.e., insolvency) increases the odds that a Sec. 1244 loss will be disallowed.

Third, the stock must be issued directly to the original owner, who is the only one entitled to claim a Sec. 1244 loss (Regs. Sec. 1.1244(a)-1(b)). In addition, the owner must be an individual or a partnership (Sec. 1244(a)). In the case of a Sec. 1244 loss passed through a partnership, the loss is deductible only by individuals who were partners both when the stock was issued to the partnership and when the loss is sustained (and then only to the extent that their partnership interest has not decreased since the stock was purchased by the partnership). Any Sec. 1244 stock held by a partnership and subsequently distributed to partners is not Sec. 1244 stock in the partners' hands (Regs. Sec. 1.1244(a)-1(c)).

Finally, the stock can be either common or preferred, provided the preferred stock was issued after July 18, 1984 (H.R. Rep't No. 98-432, 98th Cong., 2d Sess. 1581 (1984)). Common stock does not include securities convertible into common stock or common stock convertible into other securities (Regs. Sec. 1.1244(c)-1(b)). For common stock

issued before November 7, 1978, other requirements must be met. (See Regs. Sec. 1.1244(c)-1(f).)

A taxpayer who purchases an existing corporation's stock is not entitled to Sec. 1244 treatment since he or she is not the original owner of the stock. In this situation, taxpayers can avail themselves of Sec. 1244 treatment by purchasing the corporation's assets and transferring them to a new corporation.

Meeting the Gross Receipts Test

For stock to be considered Sec. 1244 stock in the year the shareholder realizes the loss, the corporation must meet a gross receipts test (Sec. 1244(c)(1)(C)). Under this test, during the five most recent tax years ending before the date the loss was sustained by the shareholder (or the life of the corporation, if less than five years), the corporation must have derived more than 50% of its aggregate gross receipts from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks or securities.

However, the gross receipts test does not apply if the corporation's cumulative deductions (excluding the NOL carryover and carryback deduction and the special dividends-received deductions) exceed its cumulative gross income during the five-year testing period (Sec. 1244(c)(2)(C)).

Even if the gross receipts test is passed (or the corporation qualifies for the exception noted in the previous paragraph), the stock will qualify as Sec. 1244 stock only if the corporation is an operating company for the five-year testing period (Regs. Sec. 1.1244(c)-1(e)(2)). It must not be a holding or investment company (e.g., a corporation that acquires and holds nonincome-producing real estate).

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EditorNotes

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