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SECTION 1244, SMALL BUSINESS STOCK LOSSES: A RE-ACQUAINTANCE THAT WILL SURVIVE TAX REFORM AND A PROPOSAL FOR CHANGE

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I. INTRODUCTION

The Tax Reform Act of 1986 has generated renewed concern among advisors regarding the tax treatment accorded investment losses sustained by those individuals who suffer a business failure through either a complete business collapse or a distressed, liquidation/sale of business assets. In the context of the corporate form of business, tax planning for such losses may permit an investor to immediately recover at least a portion of any lost investment through the use of section 1244 of the Internal Revenue Code (the Code). Although this “recovery” objective is what first prompted Congress, in part, to enact section 1244, the issues raised by the Tax Reform Act of 1986 concern whether or not the mechanics of that recovery objective remain intact due to significant changes in the tax treatment afforded capital gains and losses. While many advisors, over time, have seemingly disregarded the prospective benefits of section 1244 in deference to what may have been perceived as particularly wily rules of compliance, revisions since the section’s initial enactment have amplified its compliance, broadened its application and enhanced its utility as a tax planning tool.

This article briefly reviews the statutory framework of section 1244, noting its history of interpretation and application.

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by the Internal Revenue Service; contains a review of relevant case law developments; discusses the continued usefulness of section 1244 in light of the latest round of tax reforms; and, throughout, provides an indication of problems that might be of special interest. Additionally, part VI of the article offers a proposal for the modification of section 1244 in order to accelerate the timing of its tax benefits to the time at which a stock investment is made rather than deferring such benefits until the time at which the stock investment loss is actually realized. For brevity purposes, a discussion of the more technical provisions of section 1244 has been omitted since the application of such provisions is limited. It should also be noted that although the provisions of section 1244 apply to corporate stock issued as of various dates, this article only concerns stock issued after November 6, 1978.4

II. THE STRUCTURE OF SECTION 1244

In a statutory context, section 1244 applies only to those losses realized from stock investments in corporations that meet the definitional criteria of the section. Accordingly, the significance of section 1244 can best be appreciated by comparing the tax treatment extended capital losses (as opposed to ordinary losses) under the Code. Unlike ordinary losses which are deductible in full5 and which serve as an offset to other sources of income, capital losses are only limitedly deductible. The maximum deduction currently permitted by the Code is $3000.6

Prior to the Tax Reform Act of 1986, this capital loss limitation was further restricted when the net capital losses in-

6. I.R.C. § 1211(b)(2)(B) (1986). To illustrate this point, assume a taxpayer with interest, dividend and wage income of $30,000 operates a small business (either as a sole proprietorship, partnership or an "S" corporation) that realizes a net operating loss of $10,000 for the tax year. The $10,000 loss will be treated as an ordinary loss for the tax year and, as such, will be used to reduce $10,000 of the taxpayer's other income; the result is a reduction of the taxpayer's total taxable income for the year to $20,000. If, instead, the taxpayer realizes a net $10,000 capital (rather than ordinary) loss, the maximum amount of the loss that could be used to offset other income in the current tax year would be $3000. The loss balance of $7000 is retained for use in future tax years. Thus, the taxpayer's taxable income would be $27,000.
curred were long-term rather than short-term,\(^7\) as the former offset other sources of income only to the extent of fifty cents per dollar of loss incurred.\(^8\) Melding the capital loss limitation with the current Code provisions, which allow for the indefinite carryover of both short and long-term capital losses,\(^9\) has allowed a significant capital stock loss to be somewhat recovered but only over an extended number of successive tax years. Thus, if an individual were to realize a substantial loss of investment due to a complete business failure, such a loss would more likely be long-term and, therefore, of severely reduced tax benefit both in terms of time of recovery and of actual economic benefit.

To avoid the tax disparity between ordinary and capital losses, singular tax considerations might prompt taxpayers who are considering the formation of a business enterprise to initially adopt a non-corporate business form. However, such an election might obviate significant non-tax considerations which would otherwise dictate the preferability of conducting business in the corporate form. By permitting a corporation to elect the provisions of section 1244, the Code attempts, somewhat indirectly, to modify the emphasis that taxpayers, as entrepreneurs, might otherwise place on tax considerations when assessing the feasibility of whether a business should be conducted in the corporate or non-corporate form from its inception.\(^10\)

### A. Legislative History

Section 1244 was first introduced as a statutory addition to the 1954 version of the Internal Revenue Code through the enactment of the Small Business Revision Tax Act of 1958.\(^11\) Although this Act represented an assortment of small busi-

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7. I.R.C. § 1222 (1986) (property held for six months or less is considered short-term; property held for more than six months is considered long-term).
ness tax provisions\(^{12}\) (a number of which have since been either revoked or modified), its principal theme was the encouragement of small business investment through the creation of various income tax incentives which were collectively designed to increase both the external and the internal volume of funds available for the financing of small business corporations.\(^{13}\) Consistent with the Act's theme, the drafters of the section 1244 provisions elected to foster the commitment of new investment funds by drafting incentives that allowed for the immediate recognition of stock investment losses as ordinary rather than as capital losses. The intended effect of this change was to accelerate the tax use of the stock investment losses in order to promote a partial recovery of those losses through the tax savings that would be realized when the losses were used by the investor to offset other forms of taxable income. The drafters anticipated that by shortening the time period over which the stock investment losses could be recovered, the reluctance to assume the investment risks commonly associated with small business corporations could be effectively reduced. Although modest,\(^{14}\) the goals of section 1244 represented a fledgling attempt by Congress to equalize the availability of investment funds for those small business corporations which were attempting to maintain a semblance of competitive balance with their larger brethren.\(^{15}\)

During the twenty year period following the adoption of the Small Business Revision Act, the statutory text of section 1244 remained unaltered. The litigation engendered was largely confined to interpretive challenges regarding the various requirements for compliance, some of which were viewed as particularly burdensome.\(^{16}\) In 1978, however, reacting to

\(^{12}\) See 1958-3 C.B. 324, 326-29 (extension of net operating loss carryback allowances; twenty percent additional, first-year allowance for depreciable, tangible personal property; increase in the minimum accumulated earnings credit from $60,000 to $100,000; ten year extension for the payment of any federal estate tax imposed upon estates having a closely-held business as the most significant asset in the estate).

\(^{13}\) See 1959-2 C.B. 709, 710.

\(^{14}\) See id. at 709 (projections indicated that adoption of the proposed section 1244 provisions would result in no immediate revenue loss to the Treasury).

\(^{15}\) Id. at 710.

\(^{16}\) See, e.g., Malinowski v. Commissioner, 71 T.C. 1120 (1979) (failure to adopt a plan); Harwell v. Commissioner, 33 T.C.M. (CCH) 669, 43 T.C.M. (P-H) ¶ 74,153 (1974) (failure to adopt a plan); Farr v. Commissioner, 32 T.C.M. (CCH) 1366, 42
both the engine of inflation in the economy and the various challenges debated in the section 1244 matters litigated, Congress tinkered with some of the dollar limitations imposed\textsuperscript{17} and revised some of the compliance requirements\textsuperscript{18} by adopting the amendatory provisions of the Revenue Act of 1978.\textsuperscript{19} Although the 1978 Act's amendments to section 1244 were philosophically compatible with the risk and investment incentives of the 1958 Act, a new and more subtle capital formation/preservation rationale was injected into the section ostensibly to facilitate small business access to investment funds in order to catalyze the organization of new corporations and to encourage the modernization of existing plant and equipment.\textsuperscript{20}

In 1984, section 1244 was amended by the Deficit Reduction Act of 1984\textsuperscript{21} to specifically qualify preferred stock for ordinary loss treatment. Although the 1984 amendment to section 1244 was relatively minor in text, it was quite significant in scope. As a result of the qualification for preferred stock, small business corporations were provided with an opportunity to explore the preservation rationale that had first surfaced in the Revenue Act of 1978. Accordingly, small business corporations could simultaneously benefit not only from section 1244 but also from the section 368(a)(1)(E)\textsuperscript{22} recapitalization and estate "freeze" rules which rely upon exchanges of preferred stock for common stock in order to

\textsuperscript{17} Congress increased the amount of section 1244 stock that a qualified small business corporation could issue from $500,000 to $1,000,000 and increased the maximum amount which individuals could treat as a section 1244 loss from $25,000 to $50,000 (single return) and from 50,000 to $100,000 (joint return). 1978-3 C.B. (Vol. 1) 78, 79.

\textsuperscript{18} Congress repealed the particularly wily requirement that small business corporations issuing section 1244 stock formally adopt a written plan detailing the stock offering prior to the actual issuance of the shares. 1978-3 C.B. (Vol. 1) 78, 79. \textit{See also supra} note 16 and accompanying text.


\textsuperscript{22} I.R.C. § 368(a)(1)(E) (1986).
facilitate the tax-free transfer of a small business corporation's value and control from one generation to another. Prior to the 1984 amendment to section 1244, such an estate preservation device was unavailable to section 1244 shareholders absent a relinquishment of the section's qualification.

Most recently, section 1244 has been affected by the Tax Reform Act of 1986, wherein section 469 was added to the 1986 version of the Internal Revenue Code. As enacted, section 469 continues Congress' unrelenting assault upon the tax use of investment losses as offsets to other forms of taxable income by restricting the recognition of such losses only to the extent of any investment income realized. The availability of any excess investment loss is intended to be deferred until such time as an objective, economic assessment of the actual loss sustained can be determined. Although section 469 is a measured attack upon the limited partnership forms of investment loss, its language is sufficiently unrefined to include all forms of investment losses for which the investor realizing the loss has not had a direct or participating responsibility. The concern here is whether section 1244 shareholders who realize investment stock losses are to be included within the amorphous context of section 469.

B. Section 1244 Statutory Requirements

As the Code and regulations stipulate, section 1244 provides that a loss incurred as the result of a sale or exchange (including the determination of worthlessness) of "Section 1244 stock" will be accorded "ordinary loss," as opposed to capital loss, treatment. Such losses are then treated as deductions from gross income in determining adjusted gross income.

26. Treas. Reg. § 1.1244(a)-1(a) (as amended in 1981). Although losses due to liquidations, redemptions or declared worthlessness are not true sales or exchanges for the purpose of section 1244, such events are treated as if they were sales or exchanges.
27. For example, and again relying upon the example cited at note 6, supra, if the $10,000 net capital loss realized had been due to the sale or exchange of section 1244 stock, the full $10,000 loss would be allowed to offset other income in the year of the
In order to qualify for such ordinary loss treatment, specific requirements which relate to both the type of stock issued and the capital structure of the corporation issuing that stock must be met. Further, any ordinary loss deductions may be claimed only by those taxpayers who, as individual shareholders, satisfy additional requirements of the Code and the regulations. Losses incurred by corporations, trusts or estates which may be shareholders are specifically disqualified from claiming ordinary loss treatment under the provisions of section 1244 regardless of how the small business corporation stock upon which the losses were incurred was acquired. Finally, J. Prizant v. Commissioner appears to disqualify section 1244 treatment by partners who received stock in a distribution sale from a partnership that had originally acquired the stock; the Tax Court rationale being that at the time the loss on sale was sustained, the partner/taxpayer was considered to be holding the stock other than from the issuing corporation (that is, as having been received from a partnership, even though received as a proper partnership distribution).

28. The ordinary loss provisions of section 1244 are available only for those losses which are sustained by shareholders who are either individuals to whom the stock was issued by a small business corporation, Treas. Reg. § 1.1244(a)-1(b)(1) (1981), or who are (or were) partners in a partnership at the time the partnership acquired the stock in an issuance from a small business corporation and whose distributive share of partnership items reflects the loss sustained by the partnership, Treas. Reg. § 1.1244(a)-1(b)(2) (1981).

29. Treas. Reg. § 1.1244(a)-(b)(2) (1981). Note also, that sales or exchanges with related individuals might be disqualified through application of the attribution rules of I.R.C. § 267 (1986). In general, the intention of section 1244 is to distinguish original investors from subsequent purchasers and to extend preferential tax treatment to the former, in part as an acknowledgment of the inherent risks assumed by shareholders who invest capital in either a new or an existing corporate enterprise. Thus, individuals who acquire stock from any individual or entity other than the original issuing corporation, whether by gift, purchase, inheritance, pledge, etc., will not be entitled to claim the ordinary loss benefits of section 1244. See Treas. Reg. § 1.1244(a)-(b)(2) (as amended in 1981). See also Rookard v. United States, 71-1 U.S. Tax Cas. (CCH) ¶ 9457 (1971), 330 F. Supp. 722, 724 (D.C. Or. 1971); Harwell v. Commissioner, 33 T.C.M. (CCH) 669 (1974), 43 T.C.M. (P-H) ¶ 74,153 (1974).


31. 30 T.C.M. (CCH) 817, 40 T.C.M. (P-H) ¶ 71,196 at 860.
C. Limitations On Deductible Amounts

In addition to restrictions placed upon those individuals who can qualify for the ordinary loss deduction provisions of section 1244, the section also limits the aggregate annual deduction to $50,000 for a separate return and $100,000 for a joint return. These loss limitations apply regardless of whether or not the stock in question was issued before or after November 6, 1978. Similarly, for losses from more than one corporation, the annual loss limitations apply to the aggregate total of all section 1244 losses realized by a taxpayer in any particular year. Thus, if a taxpayer realized $150,000 of section 1244 losses from each of two different corporations in a particular tax year, his total section 1244 loss deductions would be limited to either $50,000 or $100,000, depending upon whether a single or joint tax return was filed. Section 1244 losses realized in excess of the Code limitations are treated as any other capital loss subject to the $3000 annual capital loss deduction limitation and carryover provisions previously discussed. Section 1244 loss deductions in excess of an individual’s income are treated as though they were attributable to a trade or business for the net operating loss carryback and carryover provisions of section 172.

III. Analysis of Corporation Requirements

As noted above, in order for the ordinary loss provisions of section 1244 to apply, the losses realized must result from the sale or exchange of stock that qualifies as section 1244 stock. Section 1244(c) sets forth a number of criteria which must be satisfied in determining any such qualifications. The criteria for stock issued after November 6, 1978, are:

1. That the stock issued must qualify as an equity security being common, preferred or a related issue;
(2) That the stock issued must be issued by a domestic corporation which qualifies as a "small business corporation;"\textsuperscript{37}

(3) That the stock issued was issued by such small business corporation for money or property (other than stock or securities),\textsuperscript{38} and

(4) That during the preceding five taxable years (or less, if the corporation has been in existence for a period of time less than five years) the small business corporation issuing the stock must have derived over fifty percent of its gross receipts (not gross income) from sources other than certain types of generally passive investments.\textsuperscript{39}

With the exception of the last criterion (that is, the "gross receipts test"), the section 1244(c) criteria enumerated must be satisfied at the time the stock in question is first issued to the shareholder claiming the section 1244 loss. In contrast, the gross receipts test may only be determined at the time a shareholder sustains an actual loss on the stock.\textsuperscript{40}

Prior to the enactment of the Deficit Reduction Act of 1984,\textsuperscript{41} only common stock could qualify as "section 1244 stock." With the adoption of the Act, section 1244 stock was redefined as "stock in a domestic corporation."\textsuperscript{42} Thus, the "common stock" criterion was expanded and preferred stock became qualified for the ordinary loss application of section 1244 but only for stock that was first issued after the effective date of the Act (July 18, 1984). Because the section 1244 regulations have yet to define precisely what additional types of equity securities (other than common or preferred stock) will qualify for section 1244 ordinary loss treatment, it is uncertain whether the various debt/equity criteria are applicable to section 1244 interpretations. One thing that is certain is that Congress, by recognizing preferred stock as qualifying for section 1244 treatment, has amplified its intention to encourage new venture capital.\textsuperscript{43} Accordingly, as long as the scrutinized

\textsuperscript{37} I.R.C. § 1244(c)(1)(A) (1986).
\textsuperscript{38} I.R.C. § 1244(c)(1)(B) (1986).
\textsuperscript{39} I.R.C. § 1244(c)(1)(C) (1986).
\textsuperscript{40} Id.
\textsuperscript{42} I.R.C. § 1244(c)(1) (1986).
\textsuperscript{43} See supra note 41.
security represents sufficient evidence of capital truly at risk (as opposed to debt obligations that create creditor claims), arguments in support of section 1244 inclusion can be reasonably sustained.

IV. DOMESTIC/SMALL BUSINESS CORPORATION DEFINED

Only stock issued by a domestic corporation (which also qualifies as a "small business corporation") qualifies for the ordinary loss benefits of section 1244. Section 7701(a)(4) defines a "domestic corporation" as one which is created or organized in the United States or under the laws of the United States or of any State or Territory. Accordingly, stock issued by a corporation organized under the laws of any foreign country cannot qualify for section 1244 treatment.

In addition to the requirement of domesticity, a corporation must also qualify as a "small business corporation" at the time of the stock issuance. Regulation section 1.1244(c)-2 defines a small business corporation as one which, at the time of the issuance of the stock in question, has received no more than $1,000,000 in aggregate capital contributions (including paid-in surplus, that is, any amounts received in excess of par value) whether in the form of money or other property.

When determining the amount of aggregate capital stipulated, the regulations further provide that capital receipts may not be reduced for any distributions of capital (for example, dividends in the form of stock) made to shareholders even though the distributions may be corporate distributions. It should be noted that the word "aggregate" encompasses only the benefits of section 1244 that are extended to the first $1,000,000 invested in the corporation regardless of whether or not that amount was received in exchange for section 1244 stock. In effect, any amounts received by a corporation as either capital

44. I.R.C. § 1244(c)(1)(A) (1986). Note that the section 1244 rules also apply to the stock or securities of successor corporations in re-incorporation reorganizations, as the latter are recognized merely as a change in form and not as the creation of a new entity. I.R.C. § 1244(d)(2) (1986).
45. I.R.C. § 1244(c)(1)(A) (1986). See also Snedeker v. Commissioner, 47 T.C.M. (CCH) 279 (1983), 52 T.C.M. (P-H) ¶ 83,675 (1983) (stock was issued to the taxpayer by a holding company rather than to a "small business corporation").
47. Id.
contributions or as paid-in capital surplus, prior to and including any particular issuance of section 1244 stock, will accrue against the $1,000,000 limitation. To illustrate, assume that a corporation organized in 1986 issues its stock to its shareholders in exchange for $750,000 in cash. Should the corporation subsequently decide to issue additional stock, it could only issue up to $250,000 of stock that would qualify for the ordinary loss provisions of section 1244, as the $1,000,000 capital exchange limitation imposed by section 1244 would have been reached.

V. STOCK EXCHANGED FOR MONEY OR OTHER PROPERTY

Stock issued pursuant to the provisions of section 1244 must have been issued not only to the taxpayer claiming the ordinary loss deduction, but also must have been issued to that taxpayer for money or other property transferred by that taxpayer to the corporation.\(^48\) Moreover, except to the extent of the provisions of regulation section 1.1244(d)-3, stock issued in exchange for stock or securities (i.e., debt), including stock or securities of the issuing corporation, cannot qualify as section 1244 stock.\(^49\) Furthermore, neither stock issued for services rendered, or to be rendered, to the issuing corporation nor stock issued in consideration of the cancellation of indebtedness (i.e., bonds, notes) of the corporation can generally qualify for section 1244 treatment. However, if the initially stated purpose of section 1244 (that is, to generate new infusions of capital) is to have any credence, then marketable or government securities which are easily converted to cash should be excluded from this non-qualification.\(^50\)

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50. Treas. Reg. § 1.1244(c)-1(e)(3) (1981). Cf. Hollenbeck v. Commissioner, 70-1 U.S. Tax Cas. (CCH) ¶ 9236, 422 F.2d 2 (9th Cir. 1970) (disqualification of section 1244 stock issued in exchange of cancellation of pre-existing debt represented by notes; court felt that such an exchange amounted to an infusion of additional equity); Smyers v. Commissioner, 57 T.C. 189 (1971) (section 1244 disallowed where funds received by corporation for exchange of stock were used to pay debts of corporation that were personally guaranteed by the shareholder receiving the section 1244 stock).
VI. GROSS RECEIPTS TEST

Assuming that the various requirements previously discussed have been satisfied, the corporation upon whose stock the loss was realized must additionally satisfy the requirements of the gross receipts test before ordinary loss treatment can be allowed the taxpayer claiming the loss. The gross receipts test provides that more than fifty percent of the corporation’s gross receipts during its five most recent taxable years must have been derived from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of its stock or securities. If the corporation has been in existence for a period of less than five taxable years, then the fifty percent gross income test will apply only to those taxable years during which the corporation has been in existence.

It should be noted that for purposes of section 1244, the term "gross receipts" is not synonymous with the term "gross income." The thrust of section 1244 is to measure a corporation’s accrued or actual cash receipts unaffected by its normal accounting reductions for returns and allowances, costs of goods sold or other deductions. Accordingly, and as the regulations stipulate, “gross receipts will include the total amount received or accrued during the corporation’s taxable year from the sale or exchange ... of any kind of property, from investments, and for services rendered by the corporation.” However, the regulations are not absolute. They provide that certain items of income (i.e., loan amounts received, repayment of loans previously extended by the corporation, capital contributions, proceeds received by a corporation from the issuance of its own stock, and amounts received by the corporation as the result of non-taxable sales or exchange) are to be specifically excluded from the gross receipts computation. The inclusion of these items is intended to preclude the corporation from artificially inflating its total gross receipts in order to reduce passive gross receipts to less than fifty percent. To

55. See supra note 41.
illustrate, assume that a corporation has $1000 in gross receipts including $450 of passive income and $200 of loan repayments. Without excluding the $200 loan repayment, the corporation derives more than fifty percent of its gross receipts from non-passive sources (that is, $550/1,000 or fifty-five percent). By excluding the $200 loan repayment proceeds, the corporation fails the test as its gross receipts from non-passive sources comprises less than fifty percent (that is, $350/800 or approximately forty-four percent).

For those corporations that have realized net losses during the five year gross receipts test period, the gross receipts test will not be applied because of an exception provided at section 1244(c)(2)(C). Under this exception, the gross receipts test will not apply to those corporations whose allowable deductions exceed its gross income. Taking the exception literally, it would appear that any net loss could qualify a corporation for section 1244 ordinary loss treatment regardless of the fact that any or all of its gross receipts were of a character specifically prohibited by the gross receipts test. As such an outcome might abrogate the necessity for the gross receipts test for loss corporations, regulation section 1.1233(c)-1(e)(2) has spawned yet a further exception in that stock for those corporations realizing net losses may not enjoy ordinary loss treatment unless those corporations can additionally demonstrate that they were "largely operating companies" during the five taxable years preceding the section 1244 loss claim. Because neither the Code nor the regulations elaborate on the standards to be applied to the determination of the "operating" definition, a dispute has arisen between practitioners and the Treasury regarding the statutory intent of Congress when section 1244 was first enacted. The practitioners, citing congressional commentary, maintain a literal interpretation, arguing that since section 1244 was enacted, in part, to provide incentives for investments in fledgling business enterprises, the intent of Congress was to extend ordinary loss treatment to any loss corporation regardless of whether the loss generated was actual or passive. Thus, for the Treasury to demand compliance by non-operational, passive-loss corporations with a
standard not enunciated in the Code is both inequitable and insupportable.\textsuperscript{56}

To the contrary, the Treasury maintains that the loss exception carved out of section 1244 was intended only for those corporations that were never really organized.\textsuperscript{57} Thus, if the section 1244(c)(2)(C) exception was not available for such corporations, the receipt of any amount of passive or non-operational income would prove fatal under the gross receipts test. Under this view, those loss corporations formed principally for investment purposes could not qualify as operational enterprises since any receipts realized would be of the passive character specifically sanctioned by the gross receipts test.

The respective positions of the Treasury and the practitioners were first put to the test in Bates v. United States.\textsuperscript{58} In Bates, the shareholders of an unsuccessful corporation (which had realized neither receipts nor deductions) were denied section 1244 ordinary loss treatment because the corporation failed to qualify as an operating company (for lack of any gross income). The United States Supreme Court, phrasing its determination of the "largely an operating company" standard, stated: "To so qualify (as largely an operating company) it is concluded that it must be shown that if gross receipts \textit{had been received} . . . it is probable that more than fifty percent of said gross receipts would have been derived from sources other than passive sources . . . ."\textsuperscript{59} Amplifying the test enunciated, the Bates court concluded that the corporation's intended activities "could only have led to passive income"; and, accordingly, that the corporation failed to qualify as an operating company. Thus, the court interpreted the "largely an operating company" standard to be one of prospective application: "Except as qualified by the word 'largely,' an 'operating company,' as here used, is a company that derives its gross receipts from non-passive sources, that is, income other than 'royalties, rents, dividends, interest, an-

\begin{itemize}
\item \textsuperscript{56} Davenport v. Commissioner, 70 T.C. 922, 934 (1978) (Featherston, J., dissenting).
\item \textsuperscript{57} \textit{Id.} at 926. The court used the phrase "never got off the ground" to make a statutory interpretation that has no substantive basis in either the statute or the committee reports. \textit{Id.}
\item \textsuperscript{58} 76-1 U.S. Tax Cas. (CCH) ¶ 9367 (1976), aff'd, 581 F.2d 575 (6th Cir. 1978).
\item \textsuperscript{59} Bates, 76-1 U.S. Tax Cas. (CCH) ¶ 9367, at 83,946 (emphasis added).
\end{itemize}
nuities or sales or exchanges of stock.'” Regulation 1.1244(c)-1(g)(2) is consistent with section 1244 and places no limitation on the breadth of operations of a small business corporation, except the income source.61

On appeal, the Sixth Circuit dispatched the practitioners’ “congressional intent” argument by stating that “[s]ince the regulation implements one of the underlying purposes of the Act in a reasonable manner, the fact that ‘largely an operating company’ is found in the legislative history rather than in the statutory language is unimportant.”62

Shortly after Bates was decided, the same issues were considered by the Tax Court in the Second Circuit case of Davenport v. Commissioner.63 Factually distinguished from Bates in that receipts had actually been realized, Davenport involved a loss corporation that had actively operated a small loan financing business for a number of years and derived more than fifty percent of its gross receipts from interest revenues. The tax court in recognizing the otherwise passive character of the interest revenues generated by the taxpayer’s actively conducted business operations, adopted the Bates reasoning regarding the passive nature of future income receipts and denied the shareholder involved section 1244 ordinary loss treatment. In support of its decision, the Tax Court maintained that the corporation in question could not be considered an operating company (within the confines of the Bates decision) because “[i]ts primary source of gross receipts was interest” and, that had the corporation continued in business, “its primary source of gross receipts would have remained interest.”64 The Tax Court acknowledged that the effect of its decision might well be to prevent stockholders in small loan companies from ever qualifying for section 1244 treatment (regardless of the active conduct of its business operations). However, it did emphasize that its decision was consistent with prior gross receipts decisions involving subchapter S corporations which recognize that the court will not “look be-

60. Id. at 83,945.
61. Id.
63. 70 T.C. 922, 930 (1978).
64. Id.
hind the extent of activities that generated the income” and will “look only to the plain meaning of the words used to define the income [that is, interest].” The Davenport holding spawned two significant dissenting opinions both of which chided the majority for faulty, even absurd, reasoning. The dissents argued that the adoption of a passive income concept for receipts prospectively or actually received, would unilaterally disqualify a number of actively operating loss companies from ever benefiting from section 1244. The respective dissents concluded that such a result would be inequitable absent more clearly defined (that is, statutory) standards by which the actual operations of a loss corporation (and not the singular nature of its income) could be adjudged as operating or passive.

Although the tenor of the Davenport dissents would lead to the conclusion that a revised definition of the operating company standard was possible, such has not proven to be the case. Only two decisions (both unsuccessfully) in the years since Davenport have raised the “operating” issue in the Tax Court. Nevertheless, two relatively recent Tax Court decisions concerning passive income receipts prompt the inference that the issue remains unresolved. In Omaha Aircraft Leasing Co. v. Commissioner, the Tax Court went to great lengths in favorably noting a list of criteria for use in determining the extent of a small lending company’s operations, a determina-

65. Id.
67. See Davenport, 70 T.C. at 943 (Judge Wilbur asserts that in assessing passive income “the regulations under both sections 1371 and 1244 make it clear that the nature and extent of the underlying activity producing the income—not just the income itself—must be examined in light of the legislative purpose”).
70. Omaha Aircraft Leasing Co. v. Commissioner, 74 T.C. 251 (1980). Note the comparison to section 542 as the court made reference to the need to recognize underlying corporate activities as an announced objective of Congress: “The exceptions [in section 542(c)] are provided because the types of companies involved are engaged in an active trade or business despite the nature of their income” (emphasis added). S. REP. No. 2047, 87th Cong., 2d Sess. ___ (1962), 1962-3 C.B. 248. See also S. REP. NO. 830, 88th Cong., 2d Sess. ___ (1964), 1964-1 C.B. (Part 2) 614; Malinowski v. Commissioner, 71 T.C. 1120 (1979) (regarding the relatively small number of loans actually approved).
tion not otherwise necessary were the court to deny section 1244 treatment simply on the basis of the passive character of the interest receipts realized. On the other hand, in *Eller v. Commissioner*, the Tax Court noted a pattern of consistency in the Code with regard to the exclusion of passive income as a substantiation for the recognition of operational activities by any corporation. In light of the vigor with which the Internal Revenue Service has contested the passive income aspects of the operating company exception, it would appear that the passive income rules put into place by the Tax Reform Act of 1986 can only serve to solidify the Internal Revenue Service's interpretation of the *Davenport* holding.

Left unanswered throughout this discussion is the question of whether the use of a holding company arrangement, particularly for passive income companies, could re-characterize the nature of the passive receipts generated by a subsidiary as income from services (rather than as dividends) when the same are remitted. The issue was first raised in *Bates* where the court noted that a payment resulting from a service contract arrangement (in the place of a dividend payment) might allow for the inference of active, as opposed to passive, operations by all parties concerned. The issue has yet to be tested.

In light of the foregoing, and of particular note in attempting to further refine the gross receipts/passive income definition, are the following regulation provisions:

(a) "Rents" are defined as "amounts received for the use of, or the right to use, property (whether real or personal) of the corporation . . . ." But, such terms do not include payments received for the use or occupancy of rooms or other space where "significant services" are also rendered to the occupant (*i.e.*, hotels, motels and parking lots). If the services rendered are those which are customarily rendered in conjunction with the longer-term leasing of space, then any amounts received would be deemed rent. For example, the provision of refuse removal, utilities, general maintenance and cleaning of common areas would not constitute sufficient "sig-

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72. *Id.* at 953.
significant services" to cause any rents received to be characterized as non-passive. Thus, rents from residential apartments, office and store leases, are generally considered to be rents for the purposes of applying section 1244. Beyond these points the Internal Revenue Service has not amplified its definition of "significant services" in either the regulations or published rulings.

(b) The term "interest" includes any amounts received for the use of money including any tax exempt amounts received.

VII. SECTION 1244 AFTER THE TAX REFORM ACT OF 1986

But for two significant exceptions, the vitality of section 1244 remains unaltered by the Tax Reform Act of 1986. However, a degree of caution is recommended particularly as regards the second of the two exceptions noted.

The first exception concerns a change in the taxation of capital losses and results from the discarding of the distinction between ordinary and capital gains treatment. Henceforth, long-term capital losses will be deductible in full against ordinary income, the need to generate two dollars of long-term capital losses to achieve one dollar of tax loss having been eliminated. However, the $3000 annual loss limitation remains unchanged. In effect, and dollar for dollar, capital losses and section 1244 losses will be accorded similar tax treatment. The significant difference which remains is the time period over which those losses can be recovered.

The second and more significant exception concerns section 469 and the newly enacted passive income rules. Prior to the Tax Reform Act of 1986, there were virtually no restrictions or limitations placed upon the ability of a taxpayer to use deductions or credits from a passive investment activity to offset (shelter) income from unrelated, non-investment sources such as wage or salary income, dividends and interest

75. Id.
(described by reform law as "positive source income"). Section 469 of the Tax Reform Act of 1986, however, completely reverses prior tax law and now directs that losses generated by what are described as "passive activities" can no longer be used to offset positive source income, but must first be used to offset income from other passive activities. Any unused or disallowed losses or credits are to be carried forward (not backward) and applied against passive activity income in succeeding tax years. Moreover, any unused or disallowed losses or credits can only be recovered in full when a taxpayer disposes of his entire interest in the passive activity that yielded the loss in a transaction that will be considered taxable. Additionally, any unused or disallowed losses or credits recovered must first be applied to any gain realized on the disposition of the underlying asset; the remaining balance, if any, is to be used as an offset for any available positive source income. Interestingly enough, the legislative history of the passive rules makes no reference to the manner by which unused or disallowed losses or credits are to be applied in the event the underlying asset is disposed at a loss. Presumably, the unused or disallowed losses or credits can first be applied to offset any available positive source income and then any capital loss portion can be applied to any positive source income remainder. However, within the context of the passive activity rules, the precise treatment of this capital loss element is unclear not only for section 1244 purposes but also for net operating loss applications.

In and of itself, the use of passive losses to shelter non-passive income is not an unreasonable economic concept. However, in far too many instances, available losses and credits in excess of the real (or even measurable) economic costs or losses actually borne by a taxpayer were being used in increasingly abusive income sheltering schemes. To deter further

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81. Id.
82. I.R.C. § 469 (g) (1986).
abuse, and to reiterate policy objectives, Congress seized the passive income issue as an opportunity to re-instill the idea that, in order for tax preferences to function as originally intended, the benefits of such preferences should be directed primarily to only those taxpayers who have both a substantial and a bona fide involvement in the activities to which the preferences relate.85 This concept does not, by definition, exclude non-participants as that might seriously affect investment and capital flows, particularly for new or emerging business enterprises. Rather, this concept re-acknowledges the risk incentives that undergirded the initial enactment of section 1244 to the effect that non-participating investors, per se, should not be permitted to use tax benefits to shelter income unrelated or unexposed to the risks associated with the income or activity that gave rise to those benefits.

Passive activities are generally defined as profit activities (regardless of whether or not such activities constitute a trade or business, for example, hobby activities) in which a taxpayer (or spouse) does not materially participate through regular, continuous or substantial involvement; and, rental activities where payments received are primarily for the use of tangible, personal property (for example, equipment leasing activities).86 The definitional rules apply regardless of whether or not the taxpayer directly owns an interest in the activity.

As a concession to the wide-spread use of real estate investment activities, losses and credits up to $25,000 resulting from all such activities may continue to be used to offset positive source income provided that the taxpayer claiming such loss and credit amounts "actively" participated in the real estate rental activity that generated the losses and credits claimed.87 Accordingly, losses from a typical real estate limited or general investment partnership will not be allowed within the confines of this latter exception (because of the lack of "active" participation by most investors) while losses and credits from real estate activities "actively" owned, managed or operated by a taxpayer will be so allowed. Although not of

86. I.R.C. § 469(c) (1986).
focus here, it should be noted that the Code phrases "material participation" and "active participation" are not synonymous in either definition or application, the former being deemed irrelevant, and the latter being scrutinized for corroboration within the passive activity requirements of actual participation and involvement in the real estate activities conducted.

Although the passive activity rules provide no specific reference to section 1244, the transition is easily anticipated for small business corporation shareholders who hold shares merely as an investment and who do not "regularly, continuously or substantially" involve themselves in the operational activities of the corporation. Thus, at issue are the questions of whether or not a section 1244 stock investment should be considered a passive activity and, pending resolution of that question, whether any losses realized upon the sale or exchange of any shares held will be only limitedly recognized.

For section 1244 shareholders who are actively and significantly involved with either the operational or managerial activities of the business corporation in which they hold section 1244 stock, it would appear conclusive that any stock investment so held will not be characterized as a passive activity under the "material participation" standard. Additionally, any losses realized (or credits available) upon the sale, exchange or declared worthlessness of any such shares will continue to enjoy the benefits of the ordinary loss provisions of section 1244.

For those shareholders who are not actively or significantly involved with either the operational or managerial activities of the business corporation in which they hold section 1244 stock, the answer to whether such an investment should be characterized as a passive activity is not as easily discerned. The obvious lack of "regular, continuous or substantial" participation in the affairs of the corporation would initially appear to be fatal to any conclusion other than the characterization of a passive activity. Thus, absent either a statutory exception or a definitional exclusion, non-participat-

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90. I.R.C. § 469(g) (1986).
ing shareholders would be exposed to the stringent provisions of the passive loss rules.

To address the concerns raised with regard to non-participating section 1244 shareholders, both a definitional exclusion and a statutory exception is available. With respect to the definitional exclusion, it seems clear that the passive loss rules will not apply to a section 1244 shareholder except upon a disposition of that shareholder's stock interest, an event which the Code recognizes as a true reflection of the taxpayer's actual loss. Accordingly, the Code has provided that any losses realized by a taxpayer upon a disposition of that taxpayer's interest in a passive activity can be recognized and applied by that taxpayer as an offset to other income regardless of whether or not that other income is passive.

Although the exclusion appears simple enough, one of the questions it engenders is whether it applies only in the event of a disposition of a shareholder's entire stock interest or whether the exclusion is available for partial dispositions. The answer to this question is unclear. The Senate Committee Report addresses the question but only in terms of a gain, not a loss. It specifically provides that gains from partial dispositions of passive activity interests are to be considered as passive income amounts offset only by losses or credits from other passive activities; and, that such partial (gain) dispositions are not to be treated as dispositions sufficient to trigger the recognition of all prior suspended (operating) losses that might be attributable to the particular investment disposed. Using this rationale, it can be concluded that any losses realized upon the partial disposition of any section 1244 stock interests would (if considered as being derived from a passive activity) be considered as passive. Only in the event of a full and complete disposition would any losses realized be available as an income offset.

Although the passive characterization for partial dispositions can be sustained by the argument that a partial disposi-

91. See supra note 78.
93. I.R.C. § 469(g) (1986).
tion cannot fully recognize the true economic loss that might (or might not) eventually be realized, it belies the reality of the marketplace. If a partial disposition of section 1244 stock yields a loss, the market has simultaneously evaluated both the past performances and the prospective opportunities for appreciation of the stock investment. To accord passive loss characterization for a partial disposition and non-passive characterization only upon a complete disposition is an artificial limitation that ignores the fact that an economic loss has been incurred in a taxable event. Whether or not any retained stock interest will yield a subsequent gain is wholly conjectural. At the very least, a pro rata recognition of suspended losses upon a partial section 1244 stock disposition would be more realistic.

A corollary issue raised in conjunction with that of partial dispositions concerns whether or not the term "disposition" is to have a restricted or a more expansive meaning. As provided in the Joint Committee Report, the term "disposition" contemplates not only a sales transaction (with the usual attribution rules applicable) but also the declared worthlessness of a security, events both recognized by section 1244 provisions.

With regard to the statutory exception available to section 1244 non-participating shareholders, the passive income rules provide a significant exception for what is described as portfolio income investments. Essentially, portfolio income (which is not to be treated as income from a passive activity) includes investment income such as dividends, interest, royalties and annuities not derived in the ordinary course of any trade or business. Additionally, included within the definition of portfolio income is any gain or loss attributable to the disposition of any of the following: (a) property that normally produces interest, dividend, royalty or annuity investment income, or (b) other property that is held for investment and which is not used in any type of passive activity by the holder. Accordingly, for non-participating shareholders, any section 1244 stock held only as an investment might very well be classified as a portfolio asset and, thereby, be exempted from any application of the passive income rules. Should this occur, the

95. See supra note 76.
96. See supra note 91.
issues raised with regard to whole or partial dispositions become moot.

One concern that arises, nevertheless, relates to the wording of the portfolio income definition itself, namely, that language which pertains to the description of property that "normally" produces interest, dividend, royalty or annuity income as being considered a portfolio asset. As a general rule, closely-held corporations do not "normally" pay dividends; in fact, were a corporation able to pay dividends, the need for the availability of section 1244 would most likely be obviated by fiscal health. Accepting the argument that corporations that do not normally pay dividends might be distinguished from those that do, and that only the latter should be considered portfolio assets, the former might, nevertheless, still be characterized as portfolio assets within the definitional exception extended for "other property assets" held for investment purposes and not used in any type of passive activity by the holder.97

VIII. SUMMARY AND A PROPOSAL FOR CHANGE

In summary, for section 1244 shareholders who actively participate in either the management or operations of the corporation in which the section 1244 stock is held, the passive income rules pose no concern. For non-participating shareholders, both the disposition rules and the portfolio asset exceptions offer the potential for relief. Whether the conclusion that these provisions can serve as sources of absolute relief is unclear in light of the concerns expressed with respect to both partial dispositions and to corporations that do not actually pay dividends. Nevertheless, sufficient legislative commentary exists to conclude that section 1244 stock losses can be sustained as portfolio assets. By way of recommendation, a technical correction which would explicitly provide that section 1244 stock losses are not to be considered within the passive income rules would effectively preclude further concern regarding the points raised within this article.

If the expressed intent of the 1958 Small Business Revision Act98 (to encourage the flow of investment funds into small

98. See supra note 3 and accompanying text.
business corporations) is still a vibrant objective, why not achieve that objective prospectively rather than consequently? If one of the most significant problems associated with capital formation for embryonic corporate enterprises is the reality of speculative risk, why not entice investors prospectively rather than consequently? If the spirit of section 1244 is to allow investors to minimize the stock investment loss effects of an admittedly disastrous investment decision, why not entice those investors with an investment option that allows them to enjoy, prospectively, a real economic return on the risk capital advanced by them, rather than penalizing them with the burden of foregone opportunity costs in the guise of a partial investment recovery through the provisions of section 1244?

Rhetorical questions aside, the tax incentive spirit of section 1244 is, perhaps, its most enduring quality. The notion that embryonic corporate enterprises can be germinated with investment dollars oblivious to the potential for the loss of those dollars is unrealistic. Capital formation only becomes viable for small business corporations when initial investor concerns for enterprise preservation are eventually shunted aside by fortuitous concerns regarding enterprise growth, market development and realized appreciation. At those points, capital literally, as the adage begs, "beats a path to your door."

What is needed, then, is a scheme of investment tax incentives that recognize the need to induce or entice speculative investment capital by accelerating the recovery of the dollars put at risk. Through such an acceleration, an investor might be more readily receptive to the rationale that assumed risks can translate into concepts of real economic returns through dollars in hand. The net result is a reduced cash cost for the investment, prospectively.

In order to accomplish such an acceleration, this author proposes that the net tax effects of section 1244 be realized at the time that the investment capital is actually committed rather than deferred to the time of the realized loss. Determination of the net income tax effects would be no less objective provided that dollar limitations were put into place. For example, an income tax deduction (not an exclusion) would be allowed for individual investors to the extent (not to exceed $50,000, $100,000 for those filing jointly) of their actual dollar
investment in the stock of a newly formed corporation (or a corporation formed or reorganized in order to execute a leveraged buy out transaction) whose total capital upon formation does not exceed $1,000,000. Such a deduction would be specifically excluded from the application of the passive activity rules of section 469 and be available only for those individuals who were residents of the state of incorporation for at least one year preceding the investment, limited to a stock ownership position not to exceed five percent per investor of the issued and outstanding stock of the corporation formed, and confined to individual investors of at least eighteen years of age, to the exclusion of corporations, trusts or partnerships. Further, investors taking advantage of the deduction would have to agree to retain the investment for a minimum period of three years. In exchange for the holding period commitment, any original investor who subsequently sells any shares held at a gain would be allowed to exclude fifty percent of any gain realized when determining taxable income for the year of sale.

By encouraging the formation of new corporations through the use of income tax deductions for the actual amount of the investment made rather than for the eventual amount of any loss realized, the actual cash costs to an investor could be immediately, albeit partially, recovered. In this manner, investment risks can be reduced with the anticipation of a significant diversion of capital flows in favor of small business corporations and away from more traditional, less speculative, forms of investment.