12-31-1980

The Unfinished Business of Section 1244: Removing the Remaining Traps

J. Clifton Fleming Jr.
BYU Law, flemingc@law.byu.edu

The Unfinished Business of Section 1244: Removing the Remaining Traps

By J. CLIFTON FLEMING, JR.

The author maintains that changes should be made to Section 1244 regarding partnership incorporations, contributions to capital, stock transfers to voting trusts and Section 1371(e)(1)(A) grantor trusts.

J. Clifton Fleming, Jr., is a professor of law at J. Reuben Clark Law School, Brigham Young University, and a member of the Utah and Washington Bars.

I. Introduction

In 1958 § 1244 [1] was added to the Internal Revenue Code to "encourage the flow of new funds into small business." [2] The encouragement took the form of "reducing the risk of a loss for these new funds" [3] by giving investors an ordinary instead of capital deduction for loss on investments in the common stock of small corporations.[4] Prior to 1978, however, § 1244 was hedged with formal restrictions, chief among which was the rule that only stock issued pursuant to a written plan containing required, detailed language was eligible for § 1244 coverage.[5] These restrictions often operated as traps for the unwary which denied § 1244 treatment to investors who were clearly within the class of intended beneficiaries but who foundered on one or more of the section's formalities.[6] The 1978 Revenue Act significantly eased these restrictions by abolishing the plan requirement.[7] As a result, the first $1

[1] All statutory references are to the 1954 Internal Revenue Code.

[2] H. Rept. No. 2198, 85th Cong., 1st Sess., 1959-2 CB 709, 711.

[3] Id. See also Staff of Joint Committee on Taxation, 95th Cong., 2d Sess., General Explanation of the Revenue Act of 1978 at 195 (Comm. Print 1979).

[4] Secs. 1244(a) and 1244(c)(1).

[5] See Treas. Reg. § 1.1244(c)-1(c).

[6] See Committee on Sales, Exchanges and Basis, "Report on Tax Section Recommendation No. 1974-15," 27 *Tax Lawyer* 922-24 (1974).

[7] P. L. 95-600, § 345.

million of common stock issued by a domestic corporation is now generally covered by § 1244 without the necessity of first satisfying formal requirements.[8]

Although the 1978 revision has made § 1244 more accessable to the intended beneficiaries, the section nevertheless continues to contain traps which interfere with full realization of its objective. Those traps result primarily from the rule that § 1244 does not apply to transferred stock and from the exclusion of shareholder contributions to capital from § 1244 coverage.

II. The Problem of Voting Trusts and Grantor Trusts

Section 1244 states that its benefits are available only to individuals who own § 1244 stock outright or as partners.[9] Treas. Reg. § 1.1244(a)-1(b) expands on this portion of the statute as follows:

> In order to claim a deduction under section 1244 the individual, or the partnership, sustaining the loss, must have *continuously* held the stock from the date of issuance. A corporation, *trust*, or estate is not entitled to ordinary loss treatment under section 1244 regardless of how the stock was acquired. (Emphasis added.)

This regulation is a problem because it can be interpreted as holding that a transfer of stock to a voting trust, a § 1371(e)(1)(A) grantor trust[10] or a creditor under a pledge agreement causes the stock to lose § 1244 status for violation of the regulation's continuous holding requirement and, in the case of a transfer to a trustee, for the additional reason that the stock is held in trust at the time of loss.[11]

This probably amounts to no more than a remote, theoretical issue with respect to a pledge. A pledgee has been held not to be a shareholder of pledged stock for Subchapter S purposes[12] and the transferor-debtor rather than the pledgee is considered the owner of pledged stock for purposes of determining the party to whom dividends are taxable.[13] Accordingly, there seems little likelihood that stock transferred by the original owner to a pledgee as security for a debt would be considered conveyed to a new owner in violation of the continuous holding requirement in the above regulation. Nevertheless, a revenue ruling laying this point to rest would be welcome.

This issue is, however, substantially more serious with respect to transfers of § 1244 stock to voting trusts and to § 1371(e)(1)(A) grantor trusts. The above-quoted regulation, if valid, can clearly be interpreted as placing such stock outside the protection of § 1244.

There is virtually no chance that the regulation will be held invalid. Concerning ordinary Treasury regulations, the Supreme Court has stated:

> [I]t is fundamental . . . that as contemporaneous constructions by those charged with administration of the Code, Regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes, and should not be overruled except for weighty reasons.
>
> [T]he issue before us is *not* how *we* might resolve the statutory ambiguity in the first instance, but whether there is any reasonable basis for the resolution embodied in the Commissioner's Regulation.[14]

The necessary reasonable basis for the regulation in question seems to be provided by the following from the 1958 legislative history of § 1244:

> This section provides ordinary loss rather than capital loss treatment on the sale or exchange of small business stock. This treatment is available only in the case of an individual and only if he is the original holder of the stock.[15]

Furthermore, the 1978 Revenue Act made amendments to § 1244 without in any way altering the

---

[8] Staff of Joint Committee on Taxation, 95th Cong., 2d Sess., General Explanation of the Revenue Act of 1978 at 195-96 (1979). For detailed discussion of the 1978 amendments to § 1244, see Barrack and Dodge, "Section 1244: Is the Intent of Congress Finally Achieved?" 6 J. Corp. Tax. 283 (1980).

[9] § 1244(a).

[10] As used in this article, the term "§ 1371(e)(1)(A) grantor trust" refers to a trust permitted to be a Subchapter S shareholder by virtue of § 1371(e)(1)(A) with the reference therein to a citizen or resident of the United States deleted.

[11] In *W. & W. Fertilizer Corp. v. U. S.*, 76-1 USTC ¶ 9130, 527 F. 2d 621, 627 (Ct. Cls. 1975), cert. den., 425 U. S. 974 (1976) the court held: "Taxpayer, however, misconceives the manner in which the 'grantor trust rules' operate. They do not, as taxpayer urges, recognize the grantor as the legal 'owner' of the property placed in trust."

[12] *Alfred N. Hoffman*, CCH Dec. 28,193, 47 TC 218, 231-35 (1966), aff'd 68-1 USTC ¶ 9284, 391 F. 2d 930 (CA-5). See also Rev. Rul. 70-615, 1970-2 CB 169.

[13] *Estate of Arthur L. Hobson*, CCH Dec. 18,637, 17 TC 854 (1951), acq., 1952-1 CB 2.

[14] *Fulman v. United States*, 78-1 USTC ¶ 9247, 434 U. S. 528, 533, 536 (1978). See also Rogovin, "The Four R's: Regulations, Rulings, Reliance and Retroactivity: A View from Within," 43 *Taxes* 756, 759-760 (1965).

[15] H. Rept. No. 2198, 85th Cong., 1st Sess., 1959-2 CB 709, 711.

construction placed on the statute by this regulation.[16] This indicates Congressional approval of the regulation.[17] But of primary importance is § 1244(e) which states: "The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section." The regulation in question was promulgated pursuant to this delegation of authority and is thus a legislative regulation which is entitled to even greater deference than the considerable respect paid to ordinary Treasury regulations.[18]

Since it is most unlikely that a court would ever hold this regulation invalid, the next issue is one of interpretation. Does this regulation in fact remove § 1244 coverage from stock transferred by an original holder to a voting trust or to a § 1371(e)(1)(A) grantor trust? There is substantial reason to believe that the Commissioner will answer affirmatively. Until the 1976 Tax Reform Act specifically provided otherwise,[19] the Commissioner consistently maintained that a transfer of stock to a voting trust or to a § 1371 (e)(1)(A) grantor trust was a transfer to a new shareholder for purposes of Subchapter S.[20] Granted, the taxpayers emerged victorious in the two reported cases where the Commissioner's voting trust position was challenged.[21] But the Commissioner won the litigation as to grantor trusts [22] and continued to officially maintain his view on both points until it was interred by the 1976 Tax Reform Act.[23]

The implications for § 1244 are obvious. If the Commissioner asserted that a transfer to a new shareholder had occurred for Subchapter S purposes when stock was conveyed to a voting or grantor trust, there is good reason to assume that he will consider such a conveyance to also be a transfer which violates the continuous holding requirement of the regulation in question. And given the Commissioner's success rate in litigation, it must be assumed that the courts would agree with this interpretation of the regulation if the Commissioner advanced it.

Of course, the Commissioner ought not to move in this direction. Trustees of both voting trusts and § 1371(e)(1)(A) grantor trusts hold transferred stock in only a formal capacity while the transferor remains the owner in substance. Any loss realized with respect to the transferred stock will be reported by the transferor, not by the trust.[24] Furthermore, the voting trust in particular is a very useful device for resolving control problems in precisely the small corporations which Congress intended to be the beneficiaries of § 1244. Since there is nothing involved in a transfer of stock to a voting trust or § 1371 (e)(1)(A) grantor trust which interferes with the investment stimulus purpose [25] of § 1244, it seems inconceivable that Congress intended to require shareholders to forego these common and useful devices as the price of obtaining § 1244 coverage. For these reasons, the Commissioner ought not to interpret the regulation in question as causing loss of § 1244 coverage when such transfers occur.

The problem with the foregoing arguments is that they are precisely the points which the Commissioner rejected when he adopted his pre-1976 Tax Reform Act position on stock transfers to voting and grantor trusts for Subchapter S purposes.[26] Thus there is substantial danger that the Commissioner will also reject these arguments in the context of § 1244 when the issue is clearly raised and hold that a transfer of § 1244 stock to a voting trust or § 1371(e)(1)(A) grantor trust destroys § 1244 coverage. It is no answer to say that taxpayers could litigate with the possibility of winning. So long as the Commissioner maintained such a position, the practical effect would be to inhibit well-advised taxpayers from making simultaneous use of § 1244 and grantor trusts and voting trusts.

If this is, or becomes, the Commissioner's position, can the transferor avoid forfeiting the § 1244 benefit by retrieving the stock from the trustee as the corporation begins to languish so that it is back in the transferor's hands when loss is realized? The answer may be no. The regulation which has spawned these difficulties states:

> In order to claim a deduction under section 1244 the individual, or the partnership, sus-

[16] Supra note 7. See also H. Rept. No. 95-1445, 95th Cong., 2d Sess., 107 and S. Rept. No. 95-1263, 95th Cong., 2d Sess., 158.

[17] *Lykes v. U. S.*, 52-1 USTC ¶ 9259, 343 U. S. 118, 126-27; *Helvering v. R. J. Reynolds Tobacco Co.*, 39-1 USTC ¶ 9282, 306 U. S. 110, 114-15 (1939).

[18] Rogovin, supra note 14; *H L. Davenport*, CCH Dec. 35,408, 70 TC 922, 927 (1978).

[19] P. L. 94-455, § 902.

[20] Treas. Reg. §§ 1.1371-1(d)(1), 1.1371-1(e) and 1.1372-4(b)(3).

[21] *Lafayette Distributors, Inc. v. U. S.*, 75-2 USTC ¶ 9609, 397 F. Supp. 719 (W. D. La.); *A. & N. Furniture & Appliance Co. v. U. S.*, 67-1 USTC ¶ 9434, 271 F. Supp. 40, 46-48 (S. D. Ohio).

[22] *W. & W. Fertilizer Corp. v. U. S.*, 76-1 USTC ¶ 9130, 527 F. 2d 621 (Ct. Cl. 1975), cert. den. 425 U. S. 974 (1976).

[23] Supra note 19.

[24] Treas. Reg. §§ 1.671-2(c) and 1.671-3(a); Rev. Rul. 57-51, 1957-1 CB 171; Rev. Rul. 72-471, 1972-2 CB 201; Rev. Rul. 71-262, 1971-1 CB 110; Rev. Rul. 75-95, 1975-1 CB 114; Rev. Rul. 71-548, 1971-2 CB 250.

[25] See text at notes 2 and 3, supra.

[26] See Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, 6-5, n. 13 (3d ed. 1971).

taining the loss, must have *continuously* held the stock from the date of issuance.[27] (Emphasis added.)

This language creates a substantial danger of the Commissioner holding that once stock has been transferred, its § 1244 status cannot be restored by a return to the transferor.

While the law remains in this uncertain state, the prudent lawyer must advise his client that a transfer of stock to a voting or grantor trust carries with it the substantial danger that § 1244 protection will be lost. For planning purposes, § 1244 coverage on the one hand, and use of voting and grantor trusts on the other, should be viewed as mutually exclusive alternatives even though nothing expressed in § 1244 or implied by its purpose warns that this would be so. There is an obvious trap lurking here for the inadequately advised taxpayer.

Since transfers of stock to voting trusts and § 1371(e)(1)(A) grantor trusts are very useful and in no way violative of § 1244's underlying policy, appropriate action should be taken to remove the present inhibitions to such transfers. Given the Treasury's broad § 1244(e) power to "prescribe such regulations as may be necessary to carry out the purposes of this section," and the fact that transfer of stock by an original holder to a voting trust or § 1371(e)(1)(A) grantor trust does not shift deductibility of loss on the stock from the transferor to the trust, it would be appropriate for this matter to be resolved by a regulation amendment stating that stock transferred to such a trust is not considered transferred for purposes of Treas. Reg. § 1.1244(a)-1(b). And since the regulation does not expressly state that such transfers violate § 1244 but merely contains ambiguous language that would permit the regulation to be so interpreted if the Commissioner wishes, the Commissioner could also clean up the matter with a revenue ruling renouncing this interpretation. Failing such administrative action, a statutory amendment would be in order.

III. The Partnership Incorporation Problem

Treas. Reg. § 1.1244(a)-1(b), which is the source of the voting and grantor trust problems, also causes a problem when a partnership business is incorporated. Such an incorporation can be by transfer of the partners' interests to the new corporation for stock, by the partners liquidating the partnership and transferring its assets to the new corporation for stock or by the partnership transferring its assets to the new corporation for stock followed by distribution of that stock to the partners in liquidation of their interests. In Rev. Rul. 70-239,[28] which deals with the basis, gain and loss consequences of partnership incorporations and which does not mention § 1244, the Commissioner held that no matter which of the three foregoing alternatives is chosen, the parties will be considered to have done the latter. Thus the ruling effectively holds that stock received by partners as a result of incorporating their business will always be deemed to have passed from the new corporation to the partnership before reaching the partners regardless of how the transaction is actually structured. Furthermore, the ruling takes the position that the partnership is a real shareholder while the stock is passing through and not a mere conduit.[29]

The problem with this is that Treas. Reg. § 1.1244(a)-1(b) states:

> An individual who acquires stock from a shareholder by purchase, gift, devise, or in any other manner is not entitled to an ordinary loss under section 1244 with respect to such stock. Thus, ordinary loss treatment is not available to a partner to whom the stock is distributed by the partnership.[30]

Thus the combination of this regulation and Rev. Rul. 70-239 arrives at the literal conclusion that stock issued in connection with a partnership incorporation can never be § 1244 stock unless the partnership is continued in existence to hold the stock.[31] But a requirement that the partnership be perpetuated as a stock depository merely imposes a cumbersome formality and trap for the unwary while doing nothing to advance the underlying purpose of § 1244.[32] Furthermore, if the

[27] Treas. Reg. § 1.1244(a)-1(b).

[28] 1970-1 CB 74.

[29] The ruling seems to treat the partnership as a § 351 transferor and provides that the partners take a § 732(b) basis in the stock they receive.

[30] The second sentence of this quotation is based on the following statement from the § 1244 legislative history:

> [S]ince to qualify for the ordinary loss treatment, the qualifying stock must be held by the individual or partnership to whom issued, loss on stock issued to a partnership which was distributed to a partner before the loss was sustained could not qualify.

H. Conf. Rept. 2632, 85th Cong., 1st Sess., 1958 U. S. Code, Cong. & Ad. News 5053, 5079.

[31] Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, 3-71—3-72 (4th ed. 1979); Mills, "Section 1244: A Tax Benefit with Very Little Burden," 64 A. B. A. J. 480 n. 5 (1978); McGuffie, 98-2d T. M., Small Business Stock A-4 (1974).

[32] See text at notes 2 and 3, supra, and Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, 4-45 n. 121 (4th ed. 1979).

stock is left in the partnership to preserve § 1244 coverage, the new corporation will be foreclosed from making a Subchapter S election. Thus, the final effect of Rev. Rul. 70-239 and Treas. Reg. § 1.1244(a)-1(b) is to make § 1244 and Subchapter S mutually exclusive for partners who incorporate even though there is no indication that Congress intended such a result.[33] The effects of Rev. Rul. 70-239 on § 1244 are clearly ill-conceived and should be eliminated.

The simplest cure for this problem would be a revision of Rev. Rul. 70-239 limiting its effect to the basis, gain and loss consequences of partnership incorporations and stating that the ruling is irrelevant to § 1244. The Commissioner should simultaneously promulgate a new ruling stating that regardless of how a partnership is incorporated, stock of the new corporation coming to rest in the partners' hands will not be deemed to have been held by the partnership for § 1244 purposes. Such a ruling would be a sensible recognition of the facts that § 1244 coverage should not be dependent on the form of incorporation transaction and that even if the incorporation is effected by a transfer of assets from the partnership to new corporation for stock followed by distribution of that stock to the partners, the partnership has only acted as a conduit and has never become a holder of the new stock in substance. If the Commissioner declines this advice, an appropriate amendment to § 1244 would be in order.

IV. The Contribution to Capital Problem

Section 1244(d)(1)(B) provides that a shareholder contribution to capital will be treated as paid for non-§ 1244 stock even though it is in fact added to the contributor's basis in § 1244 stock. Thus if an existing holder of § 1244 stock wishes to make a further equity investment in the corporation, he can get § 1244 coverage for that investment if the corporation issues a new stock certificate (assuming compliance with the § 1244(c)(3) $1 million limitation) but he foregoes that benefit if he neglects to get a certificate for additional common shares and simply makes a contribution to capital.[34] There is no distinction between these two situations sufficient to justify disparate results under § 1244. This is another trap for the unwary which is unnecessary for the accomplishment of § 1244's purposes. It would be appropriate to amend § 1244 to provide that an investment as a contribution to capital will be covered by § 1244 to the extent that stock issued in exchange for the contribution would have been covered.

Section 1244(d)(1)(B) also denies § 1244 coverage for § 1376(a) increases in stock basis resulting from § 1373(b) constructive dividends.[35] These constructive dividends are analogous to actual dividends reinvested in the corporation as capital contributions and the resulting basis adjustments should be covered by § 1244 to the same extent as in the case of ordinary capital contributions by shareholders.

V. Conclusion

The Revenue Act of 1978 amendments have increased the availability of § 1244 to unsophisticated or under-advised taxpayers by deleting the plan requirement. Substantial traps for such taxpayers still remain, however, in the case of partnership incorporations, contributions to capital and stock transfers to voting trusts and § 1371(e)(1)(A) grantor trusts. These traps are not compelled by the internal logic or underlying policies of § 1244. They are perverse elements in the § 1244 scheme which should be removed. ●

[33] See Barrack and Dodge, "Section 1244: Is the Intent of Congress Finally Achieved?" 6 J. Corp. Tax. 283, 296-98 (1980).

[34] Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, 4-49 (4th ed. 1979); McGuffie, 98-2d T. M., Small Business Stock A23 (1974).

[35] Treas. Reg. § 1.1244(d)-2(a).