Reddy v. Commissioner, 66 T. C. 335 (1976)

Stock subscribed before incorporation can qualify as Section 1244 stock if issued after adoption of a Section 1244 plan.

Summary

The Reddys subscribed to stock in their soon-to-be-formed corporation, conditioning the issuance on the adoption of a Section 1244 plan. The stock became worthless in 1970, and the issue was whether it qualified for ordinary loss treatment under Section 1244. The Tax Court held that the stock was not issued until the plan was adopted, thus qualifying for Section 1244 treatment. This case emphasizes the importance of the timing of stock issuance relative to the adoption of a Section 1244 plan.

Facts

John J. and Margaret C. Reddy planned to start an Oldsmobile dealership and deposited $84,000 into a bank account. They intended to incorporate and issue stock under Section 1244 to benefit from potential ordinary loss treatment. On June 10, 1968, they signed the articles of incorporation, which listed them as subscribers for 85,796 shares. The articles were filed on June 17, 1968, officially forming the corporation. A Section 1244 plan was adopted by the board of directors on June 21, 1968, after which stock certificates were issued. The dealership began operations on July 11, 1968. The stock became worthless in 1970, prompting the Reddys to claim an ordinary loss on their tax return.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the Reddys' 1970 tax return and denied their claim for an ordinary loss under Section 1244, asserting that the stock was issued before the adoption of the Section 1244 plan. The Reddys petitioned the U. S. Tax Court, which ruled in their favor, holding that the stock was not issued until after the adoption of the Section 1244 plan.

Issue(s)

1. Whether the stock subscribed for by the Reddys before incorporation qualified as Section 1244 stock, given that the Section 1244 plan was adopted after the corporation was formed.

Holding

1. Yes, because the stock was not issued until after the adoption of the Section 1244 plan on June 21, 1968, thus qualifying for ordinary loss treatment under Section 1244.

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Court’s Reasoning

The Tax Court’s decision hinged on the timing of stock issuance relative to the adoption of the Section 1244 plan. The court noted that the Reddys intended for their stock to be issued under Section 1244, as evidenced by their discussions with their accountant and their conditioning of the stock subscription on the adoption of such a plan. The court relied on Section 1. 1244(c)-1(c)(3) of the Income Tax Regulations, which states that stock subscribed for before the adoption of a plan may be considered issued pursuant to the plan if not issued before the plan’s adoption. The court distinguished this case from *Wesley H. Morgan*, where the Section 1244 plan was adopted after the stock was issued and paid for, and the subscriptions were not conditioned on the plan’s adoption. The court emphasized that the Reddys’ intent and the conditional nature of their subscriptions aligned with the purposes of Section 1244, which is to encourage investment in small businesses.

Practical Implications

This decision clarifies that stock subscriptions can be conditioned on the adoption of a Section 1244 plan, even if the subscriptions occur before the corporation is formed. Practitioners advising clients on the formation of small businesses should ensure that any preincorporation stock subscriptions are explicitly conditioned on the adoption of a Section 1244 plan if the client wishes to benefit from the potential ordinary loss treatment. This ruling can impact how small business incorporations are structured and documented to maximize tax benefits. Subsequent cases have cited *Reddy v. Commissioner* to support the principle that the timing of the plan’s adoption relative to stock issuance is critical for Section 1244 qualification.

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