Role v. Commissioner, 70 T. C. 341 (1978)

Section 1244 stock status does not carry over to stock received in a merger that does not qualify as a specific type of reorganization under the Internal Revenue Code.

Summary

In Role v. Commissioner, the U. S. Tax Court ruled that stock received by petitioners in a merger between their corporation, KBSI, and Micro-Scan did not qualify as Section 1244 stock. The petitioners had initially purchased Section 1244 stock in Keystone, which later became KBSI through a reorganization. After KBSI merged with Micro-Scan, creating KMS (N. Y.), and subsequently reincorporated into KMS (Del.), which went bankrupt, the petitioners claimed ordinary loss deductions. The court held that the merger did not qualify under the specific reorganizations allowed for Section 1244 stock carryover, thus the losses were capital, not ordinary.

Facts

In 1967, petitioners purchased Section 1244 stock in Keystone Manufacturing Co. , which later reincorporated as Keystone Bay State Industries (KBSI) in 1969. In 1971, KBSI merged with Micro-Scan Systems, Inc. , forming Keystone Micro-Scan, Inc. (KMS (N. Y.)). Shortly after, KMS (N. Y.) reincorporated as KMS (Del.), which went bankrupt in 1973. Petitioners claimed ordinary loss deductions for their KMS (Del.) stock under Section 1244.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' taxes, disallowing the ordinary loss deductions. The petitioners appealed to the U. S. Tax Court, which heard the case and ruled in favor of the Commissioner, denying the ordinary loss treatment for the petitioners' stock.

Issue(s)

1. Whether the stock received by petitioners in the KBSI-Micro-Scan merger qualified as Section 1244 stock under the Internal Revenue Code?

Holding

1. No, because the merger did not qualify as a reorganization under Section 368(a)(1)(E) or (F), as required for Section 1244 stock carryover.

Court's Reasoning

The court applied the rules of Section 1244, which allows ordinary loss treatment for losses on certain small business stock, but only if the stock meets specific criteria, including being received in a qualifying reorganization. The court found that the KBSI-Micro-Scan merger was a statutory merger under Section 368(a)(1)(A), not a recapitalization under Section 368(a)(1)(E) or a reorganization under Section 368(a)(1)(F). The court rejected the petitioners' argument that the merger was a "reverse acquisition" that should be treated as a qualifying reorganization. The court also upheld the validity of the regulations under Section 1244(d)(2), which limit the carryover of Section 1244 status to specific types of reorganizations.

Practical Implications

This decision clarifies that the benefits of Section 1244 stock do not automatically carry over through mergers unless they meet the strict criteria of the Internal Revenue Code. Taxpayers and their advisors must carefully structure corporate reorganizations to preserve Section 1244 status. The ruling highlights the importance of understanding the technical requirements of tax laws when planning corporate transactions. It also underscores the need for professional tax advice in complex corporate restructurings. Subsequent cases have followed this precedent, reinforcing the narrow interpretation of Section 1244(d)(2) and its regulations.

