***Davenport v. Commissioner, 70 T. C. 922 (1978)***

Stock in a small business corporation qualifies for ordinary loss treatment under section 1244 only if the corporation is largely an operating company, not merely based on its financial performance.

**Summary**

H. L. Davenport formed Greenbelt Finance, Inc. , to operate a small loan business, purchasing stock and later making loans to the corporation. The IRS denied ordinary loss treatment under section 1244 for losses on Greenbelt's stock and loans, arguing the company wasn't a "largely operating company" as its income was primarily from interest. The Tax Court upheld the IRS's position, emphasizing that the "largely operating company" requirement must be met, even if the corporation's deductions exceeded its gross income. The court also found that Davenport's stock purchases and loans were motivated by investment, not business protection, thus denying ordinary loss treatment under sections 165 and 166.

**Facts**

In 1959, H. L. Davenport left his job to start Greenbelt Finance, Inc. , a Texas corporation for a small loan business. He initially purchased 20,000 shares of the corporation's stock. Over the years, he bought more stock and made loans totaling $69,402. 48 to Greenbelt. By 1971, when Greenbelt's stock and debts became worthless, over 50% of its gross receipts were from interest, and its deductions exceeded its gross income for the five years before the loss.

**Procedural History**

Davenport filed a petition in the U. S. Tax Court against the Commissioner of Internal Revenue, challenging the IRS's determination of tax deficiencies for 1968-1972. The court heard arguments on whether Greenbelt's stock qualified for section 1244 ordinary loss treatment and whether losses on stock and loans could be treated as ordinary under sections 165 and 166.

**Issue(s)**

1. Whether Greenbelt's stock qualified as section 1244 stock, allowing ordinary loss treatment?
2. Whether losses on Greenbelt stock purchased in 1968 were ordinary losses under section 165?
3. Whether losses on loans to Greenbelt were ordinary losses under section 166?

**Holding**

1. No, because Greenbelt was not a "largely operating company" as its primary income was interest, despite its deductions exceeding gross income.

2. No, because Davenport’s dominant motivation in purchasing the stock was investment, not business protection.
3. No, because Davenport’s dominant motivation in making the loans was investment, not business protection.

**Court’s Reasoning**

The court reasoned that section 1244 benefits are limited to shareholders of “largely operating companies,” not just companies with losses. Despite Greenbelt’s deductions exceeding its gross income, the court upheld a regulation requiring the company to be an operating company to qualify for section 1244 treatment. The court rejected Davenport’s argument that the regulation exceeded the IRS’s authority, citing congressional intent to limit benefits to operating companies. The court also found that Davenport’s purchases and loans were motivated by investment, not to protect his employment, based on the significant amount invested compared to his salary.

**Practical Implications**

This decision clarifies that section 1244’s ordinary loss treatment is not automatically available to small businesses with losses but requires the business to be actively operating. Practitioners must assess whether a client’s business qualifies as a “largely operating company” beyond just financial performance. The ruling impacts how tax professionals advise clients on the tax treatment of losses from small business investments and loans, emphasizing the need to evaluate the nature of the business’s income. Subsequent cases, like Bates v. United States, have followed this interpretation, affecting how similar cases are analyzed and reinforcing the importance of the operating company requirement in tax planning for small businesses.

 