Malinowski v. Commissioner, 71 T. C. 1120 (1979)

The taxpayer bears the burden of proving that stock qualifies as section 1244 stock for ordinary loss treatment, even if corporate records are lost by the IRS.

Summary

Malinowski and Sommers, partners in ALCU, claimed an ordinary loss deduction for worthless stock in BAC, arguing it was section 1244 stock. However, they couldn't produce corporate records to prove a written plan existed for issuing such stock, as required by regulations. The Tax Court held that the burden of proof remains with the taxpayer, even if records were lost by the IRS, and the taxpayers failed to prove the stock's section 1244 status. The court also rejected alternative arguments for bad debt deductions and claims of inconsistent treatment by the IRS.

Facts

ALCU, a partnership including Malinowski and Sommers, loaned $22,000 to Business Automation of Oxnard (BAO) in 1969. BAO incorporated as Business Automation of California, Inc. (BAC), and issued 220 shares to ALCU in exchange for canceling the debt. In 1972, the BAC stock became worthless, and ALCU claimed an ordinary loss, asserting the stock qualified as section 1244 stock. BAC's corporate records were transferred to the IRS and subsequently lost. The taxpayers could not produce any evidence of a written plan required for section 1244 stock issuance.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the taxpayers' 1972 federal income taxes, disallowing the ordinary loss deduction. The taxpayers petitioned the U. S. Tax Court, arguing the loss of records shifted the burden of proof to the Commissioner and that the stock qualified as section 1244 stock or, alternatively, as a business bad debt. The Tax Court rejected these arguments and entered decisions for the respondent.

Issue(s)

1. Whether the loss of corporate records by the IRS shifts the burden of proof to the Commissioner to show that the stock did not qualify as section 1244 stock?
2. Whether the taxpayers can deduct the loss as an ordinary loss because the stock qualified as section 1244 stock?
3. Whether, in the alternative, the taxpayers can deduct the loss as a business bad debt?
4. Whether the taxpayers are entitled to treat the loss as a nonbusiness bad debt due to alleged inconsistent treatment of another partner's audit?

Holding

1. No, because the burden of proof remains with the taxpayer under Tax Court rules, and the loss of records does not shift this burden.
2. No, because the taxpayers failed to prove the existence of a written plan required for section 1244 stock.
3. No, because the taxpayers were not in the trade or business of making loans and BAC did not owe them an enforceable debt.
4. No, because the issue was not properly raised, the facts did not establish inconsistent treatment, and the Commissioner is authorized to correct mistakes of law.

Court's Reasoning

The court applied the general rule that the taxpayer bears the burden of proving the Commissioner's determination is incorrect, as stated in Rule 142 of the Tax Court Rules of Practice and Procedure. The court held that the loss of records, even if due to IRS actions, does not shift this burden, citing Federal Rule of Evidence 1004, which allows secondary evidence but does not alter the burden of proof. The taxpayers presented no evidence of a written plan required for section 1244 stock, and the available evidence suggested no such plan existed. The court also rejected the argument that the written plan requirement was unduly burdensome, noting that Congress explicitly required it. For the alternative bad debt deduction, the court found no evidence that the taxpayers were in the business of making loans or that BAC owed them a debt. Finally, the court dismissed the duty of consistency argument due to procedural defects, lack of evidence of inconsistent treatment, and the principle that the Commissioner can correct legal errors.

Practical Implications

This decision emphasizes the importance of maintaining records to support tax positions, particularly for section 1244 stock claims. Taxpayers must be prepared to prove their case even if records are lost by the IRS or others. The ruling reinforces the strict interpretation of section 1244 requirements and the burden of proof on taxpayers. Practitioners should advise clients to document stock issuances carefully and consider the implications of claiming ordinary losses. The case also highlights the limited applicability of the duty of consistency doctrine in tax disputes. Subsequent legislative changes in 1978 eliminated the written plan requirement for section 1244 stock, but this applied only to stock issued after the enactment date, not retroactively to the taxpayers' situation.

