Adams v. Commissioner, 73 T. C. 302 (1979)

Stock reacquired and reissued by a corporation does not qualify for section 1244 ordinary loss treatment unless it represents a new infusion of capital into the business.

Summary

In Adams v. Commissioner, the Tax Court held that stock initially issued to a third party, repurchased by the issuing corporation, and then reissued to the taxpayers did not qualify as section 1244 stock for ordinary loss treatment. The court emphasized that the legislative purpose of section 1244 is to encourage new capital investment in small businesses, not the substitution of existing capital. The taxpayers failed to demonstrate a new flow of funds into the corporation upon their purchase, and thus, their loss was treated as a capital loss rather than an ordinary loss. This ruling clarifies the requirement for a genuine capital infusion for stock to qualify under section 1244.

Facts

Adams Plumbing Co. , Inc. was incorporated in Florida in 1973 with 100 authorized shares of common stock issued to W. Carroll DuBose. In February 1975, Adams Plumbing repurchased these shares from DuBose and retired them to authorized but unissued status. The corporation then adopted a plan to issue section 1244 stock. On March 1, 1975, Marvin R. Adams, Jr. , and Jeanne H. Adams (the taxpayers) entered into an agreement to purchase 80 shares of this stock for $120,000, which were issued on August 1, 1975. By December 1975, the stock became worthless, and the taxpayers claimed a $50,000 ordinary loss under section 1244 and a $70,000 capital loss. The Commissioner disallowed the ordinary loss, arguing the stock did not qualify as section 1244 stock.

Procedural History

The taxpayers filed a petition with the Tax Court challenging the Commissioner’s determination of a $22,995 deficiency in their 1975 federal income tax. The case was submitted fully stipulated, and the Tax Court issued its opinion in 1979, holding in favor of the Commissioner.

Issue(s)

1. Whether stock reacquired by a corporation and reissued to new shareholders qualifies as section 1244 stock if it was previously issued to a third party?

Holding

1. No, because the stock must represent a new infusion of capital into the business to qualify as section 1244 stock, and the taxpayers failed to show such an infusion

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when they purchased the reissued shares.

Court’s Reasoning

The Tax Court focused on the legislative intent behind section 1244, which is to encourage new investment in small businesses. The court found that the taxpayers’ purchase did not result in a new flow of funds into Adams Plumbing, as the stock had been previously issued to DuBose and merely resold after being repurchased and retired. The court cited the regulation that requires continuous holding from the date of issuance, interpreting this to mean the stock must be held from the date it was first issued to the taxpayer, not from its initial issuance to any party. Furthermore, the court referenced prior cases like Smyers v. Commissioner, which disallowed section 1244 treatment where stock was issued for an existing equity interest. The court concluded that the taxpayers did not meet their burden of proof to show a new capital infusion, and thus, their loss was a capital loss, not an ordinary loss under section 1244.

Practical Implications

This decision clarifies that for stock to qualify for section 1244 treatment, it must represent a genuine new investment in the corporation, not a mere substitution of existing capital. Tax practitioners should advise clients that repurchased and reissued stock does not automatically qualify for ordinary loss treatment. This ruling may impact how small businesses structure their stock issuances and repurchases, as they must ensure any reissued stock represents new capital to qualify under section 1244. Additionally, attorneys should be aware of the need to demonstrate a new flow of funds when claiming section 1244 losses. Subsequent cases may further refine the application of this principle, but Adams v. Commissioner remains a key precedent for interpreting the requirements of section 1244.

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