***74 T.C. 4 (1980)***

For stock to qualify for ordinary loss treatment under Section 1244, the corporation must receive new funds as a result of the stock issuance; reissuing previously issued and repurchased stock, without a fresh infusion of capital, does not meet this requirement.


**Summary**

Taxpayers sought to deduct a loss on stock as an ordinary loss under Section 1244 of the Internal Revenue Code. The stock was initially issued to a third party, repurchased by the corporation, retired to authorized but unissued status, and then reissued to the taxpayers. The Tax Court denied ordinary loss treatment, holding that the reissuance of stock did not represent a fresh infusion of capital into the corporation as intended by Section 1244. The court emphasized that Section 1244 is designed to encourage new investment in small businesses, not the substitution of existing capital. Because the taxpayers failed to demonstrate that their stock purchase resulted in new funds for the corporation, the loss was treated as a capital loss.


**Facts**

Adams Plumbing Co., Inc. was incorporated in 1973 and initially issued all of its stock to W. Carroll DuBose.

In February 1975, Adams Plumbing repurchased all of DuBose's shares.

Immediately after the repurchase, Adams Plumbing sold a small portion of the stock to William R. Adams (taxpayer's brother) and retired the remaining shares to authorized but unissued status.

The corporation then adopted a plan to issue stock under Section 1244.

Three weeks later, the taxpayers contracted to purchase a significant portion of the reissued stock.

Five months after the contract, the taxpayers completed payment and received the stock. The stock subsequently became worthless in 1975.

The taxpayers claimed an ordinary loss deduction under Section 1244 for the stock's worthlessness.

**Procedural History**

The Commissioner of Internal Revenue determined a deficiency in the taxpayers' federal income tax for 1975, disallowing the ordinary loss deduction.

 

The Taxpayers petitioned the Tax Court for review of the Commissioner's determination.

The Tax Court upheld the Commissioner's determination, finding against the taxpayers.

**Issue(s)**

1. Whether stock, initially issued to a third party, repurchased by the corporation, retired to authorized but unissued status, and subsequently reissued to the taxpayers, qualifies as "section 1244 stock" for ordinary loss treatment?

2. Whether the taxpayers are entitled to ordinary loss treatment under Section 1244 when they failed to prove that the corporation received new funds as a result of their stock purchase?

**Holding**

1. No, because Section 1244 stock must be newly issued to inject fresh capital into the corporation, and reissuing repurchased stock does not inherently fulfill this purpose.

2. No, because the legislative intent of Section 1244 is to encourage the flow of new funds into small businesses, and the taxpayers did not demonstrate that their investment provided such new funds.

**Court's Reasoning**

The court emphasized the legislative purpose of Section 1244, stating, "This provision is designed to encourage the flow of *new* funds into small business. The encouragement in this case takes the form of reducing the risk of a loss for these *new* funds."

The court reasoned that while the regulations require continuous holding of stock from the date of issuance, the critical factor is whether the stock issuance represents a fresh infusion of capital. The court distinguished between original issuance and mere reissuance of previously outstanding stock. It stated, "Instead of a flow of new funds into a small business, the minimal facts of this case indicate only a substitution of capital. In the situation of an ongoing business, we think Congress wanted to encourage the flow of additional funds rather than the substitution of preexisting capital before the benefits of section 1244 could be bestowed."

The court found that the taxpayers failed to provide evidence that their stock purchase resulted in a net increase in the corporation's capital. The stipulation of facts lacked details about the financial terms of DuBose's stock repurchase and the corporation's financial condition before and after the sale to the taxpayers.

 

The court cited *Smyers v. Commissioner*, 57 T.C. 189 (1971), which denied ordinary loss treatment when stock was issued in exchange for a pre-existing equity interest, as analogous. The court noted that in *Smyers*, "no new capital is being generated. Capital funds already committed are merely being reclassified for tax purposes." The court found a similar lack of new capital infusion in the present case.

**Practical Implications**

*Adams v. Commissioner* clarifies that for stock to qualify as Section 1244 stock, the issuance must result in a fresh injection of capital into the corporation. Attorneys advising small businesses and investors seeking Section 1244 ordinary loss treatment must ensure that stock issuances are structured to bring new funds into the company, not merely substitute existing capital.

This case highlights the importance of documenting the flow of funds when issuing stock intended to qualify under Section 1244. Taxpayers bear the burden of proving that their investment resulted in new capital for the corporation. Mere compliance with the procedural requirements of Section 1244, such as adopting a written plan, is insufficient if the underlying purpose of encouraging new investment is not met.

Subsequent cases have cited *Adams* for the principle that Section 1244 is intended to incentivize new investment and that the substance of the transaction, particularly the flow of funds, is crucial in determining eligibility for ordinary loss treatment. Legal practitioners should advise clients that reissuing treasury stock or engaging in transactions that lack a genuine infusion of new capital are unlikely to qualify for Section 1244 benefits.