Frantz v. Commissioner, 83 T. C. 162 (1984)

A shareholder's non pro rata surrender of stock to the issuing corporation is treated as a contribution to capital, not a deductible loss.

Summary

Leroy Frantz, a shareholder in Andree Biallot, Ltd. (ABL), surrendered preferred stock and advances to the corporation in a non pro rata manner. He later sold his common stock. The Tax Court held that these surrenders were contributions to capital, not deductible losses, and Frantz's common stock did not qualify as section 1244 stock for ordinary loss treatment. The court overruled prior cases allowing ordinary losses on such surrenders, emphasizing that the surrendered assets' basis should be added to the basis of retained stock.

Facts

Leroy Frantz held 65% of ABL's common stock and 13% of its preferred stock. Facing financial difficulties, ABL underwent a reorganization in 1971, issuing new common and preferred stock. Frantz, who had previously made advances to ABL, exchanged these for preferred stock. In 1973, to improve ABL's financial statements and attract investors, Frantz surrendered his preferred stock and all notes and accounts receivable to ABL as a capital contribution. Later that year, he sold his common stock for $8,000.

Procedural History

The Commissioner of Internal Revenue issued a deficiency notice to Frantz for the 1973 tax year, disallowing his claimed ordinary losses on the surrendered stock and advances, and challenging the section 1244 status of his common stock. The Tax Court heard the case and issued its opinion on August 7, 1984.

Issue(s)

1. Whether Frantz sustained a loss from surrendering his preferred stock and advances to ABL in 1973.
2. Whether Frantz's common stock qualified as section 1244 stock, entitling him to an ordinary loss on its sale.

Holding

1. No, because the surrender constituted a contribution to capital, not a loss event. Frantz must add the basis of the surrendered assets to his common stock's basis.
2. No, because ABL was not a small business corporation under section 1244(c)(2)(A) when it adopted its stock issuance plan, so Frantz's common stock did not qualify as section 1244 stock.

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Court’s Reasoning

The court overruled prior decisions allowing ordinary losses on non pro rata stock surrenders to the issuing corporation. It reasoned that such surrenders are open transactions aimed at protecting or enhancing the value of retained shares, not closed transactions resulting in immediate losses. The court likened these surrenders to capital contributions, which increase the basis of retained stock. For section 1244 eligibility, ABL’s plan to issue stock exceeded the $500,000 limit set by section 1244(c)(2)(A), disqualifying Frantz’s stock from ordinary loss treatment.

Practical Implications

This decision changes how tax practitioners should treat non pro rata stock surrenders to corporations. Such surrenders are now treated as capital contributions, not loss events, affecting tax planning for shareholders in financially distressed companies. The ruling discourts attempts to convert potential capital losses into immediate ordinary losses. For section 1244 stock, practitioners must ensure the issuing corporation meets all statutory requirements, particularly the $500,000 limit on offerings and contributions. This case has been cited in subsequent decisions upholding the capital contribution treatment of stock surrenders.

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