PLANNING FOR LOSSES

Business owners are constantly advised to plan for growth. This is certainly good advice, because growing your business will be much more difficult without proper planning. However, because every new business owner risks failure, planning for losses can be just as important. Proper planning can enable you to get the most favorable income tax deductions, which may in turn ease the impact of failure and may perhaps help plant the seeds for success the next time around.

Some Basic Concepts

Our discussion on planning for losses starts with four key Internal Revenue Code (IRC) concepts. These are ordinary income, ordinary losses, capital gain, and capital losses.

Ordinary income is the term that describes your income from all sources except from property you sell outside the ordinary course of your business. For example, ordinary income includes the profit you receive for the goods or services you normally sell. *Ordinary losses* arise when you sell your normal goods or services at a loss. The IRC allows you to deduct the amount of your ordinary losses from the amount of your ordinary income. This reduces the amount of your taxable income, and so reduces the amount of your income taxes.

Capital gain is the profit you receive when you sell property other than in the ordinary course of business. *Capital losses* arise when you sell that kind of property for a loss. For example, let’s say you are an editor and you sell your old computer. This is not the kind of sale you make in the ordinary course of your business. The difference between the price you paid for the computer and price for which you sell it will be either a capital gain or a capital loss. The sale of publicly traded stock (such as shares of IBM) by someone other than a stock trader is another example of capital gains and losses. Deducting capital losses against capital gains reduces the amount of your taxable income and so reduces the amount of your income taxes.

Under the IRC, you can only deduct ordinary losses against ordinary gains, and you can only deduct capital losses against capital gains. Since most people usually have much more ordinary income than they have capital gains, ordinary losses are usually more useful than capital losses in reducing one’s taxable income.

Owners of unincorporated businesses who sell or liquidate their businesses at a loss are allowed to deduct those losses against their ordinary income. Owners of corporations who sell or liquidate their corporations at a loss are required to deduct those losses against their capital gains. If their capital losses exceed their capital gains, they are allowed to divide the loss into increments of up to $3000 per year and deduct that amount against their ordinary income. At that rate, depending on the amount of the capital loss, it may be many years before the entire loss is deducted.

To give the owners of small corporations the same deduction advantages as the owners of unincorporated businesses, Congress created IRC Section 1244. Under Section 1244, the owners of certain corporations may be entitled to take ordinary loss deductions following the sale or liquidation of their businesses. The rules governing those deductions are discussed below.

Two caveats. First, while Section 1244 applies to S corporations, owners of S corporations also have other ways in which to deduct losses. Deducting losses in S corporations will be the subject of a future article. Also, on November 6, 1978, Congress liberalized the requirements for Section 1244. As most of the readers of this magazine probably started their businesses after that date, this article will only discuss the rules that have been in effect since then.

The Rules For Section 1244

Section 1244 only gives relief to the original owners of the corporation. If you acquired your stock in the corporation from someone else, you are not eligible for Section 1244 relief.

Even if you are the original owner of your stock, it must qualify as "Section 1244 stock." That is, your stock must possess these four characteristics:

1. Your stock must be common stock, not preferred stock. *Common stock* gives the owner a right to a pro rata share of the distributed profits. *Preferred stock* gives the owner the right to receive a preferential share of the distributed profits.

2. Your stock must have been issued by a U.S. corporation, not a foreign corporation. For example, a corporation organized under Illinois law would be a U.S. corporation, while a corporation organized under Canadian law would be a Canadian corporation.

3. Your stock must have been issued in exchange for cash or other property. Services or securities are excluded from the concept of "property" under Section 1244. For an example, let’s return to our editor. Her contribution of a computer in exchange for her stock is considered a contribution of property. If, instead, she contributed editing services or the stock of another corporation, this would not be considered a contribution of property for purposes of Section 1244.

4. The owners must not have contributed more than one million dollars, in total, in exchange for their stock.

The Gross Receipts Test

Even if you are the original owner of the stock and even if your stock qualifies as Section 1244 stock, you still will not receive the benefits of Section 1244 unless your corporation passes the *gross receipts test*. The gross receipts test is not concerned with the amount of your corporation’s income. Rather, the gross receipts test looks at the type of income.

Your corporation will pass the gross receipts test if more than 50% of your corporation’s gross receipts is not "prohibited" income during the relevant time period. The relevant time period is the five years preceding the date of the loss or the number of years of the corporation’s existence, whichever is less.

"Prohibited" income is the following: royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or other securities. However, these types of income will not be "prohibited" if your corporation provides "significant services" in connection with receiving that income.

"Significant services" are those services that are beyond the "customary" kinds of services that are typically provided under the circumstances. For example, landlords who lease offices usually provide cleaning services to their tenants, so that services are probably "customary." To the contrary, landlords who lease residential apartments usually do not provide cleaning services to their tenants, so those services may be "significant." In the former case, the rental income would probably be "prohibited," and thus might cause a corporation to fail the gross receipts test. In the latter example, the rental income might not be "prohibited," and so might not disqualify a corporation.

Congress created the gross receipts test to limit Section 1244 benefits to active businesses and to bar its use by passive investors. Unfortunately, the gross receipts test may adversely affect the owners of active businesses whose corporations rent property or license intellectual property, such as software or copyrighted publications.

The Amount of the Deduction Available Under Section 1244

If your stock and your corporation's receipts qualify under Section 1244, and if you sell your stock for a loss or liquidate the business, you can deduct the full amount of your loss against your ordinary income. The annual limit for the deduction is $50,000 per year or $100,000 per year if you are married and file a joint tax return.

If, in any year, the amount of your deduction exceeds the amount of your ordinary income, you can take the excess against any capital gain. If you still have losses that you have not deducted, you can deduct them against your ordinary income for the prior three years and indefinitely against future ordinary income.

The Hidden Trap

Section 1244 contains a hidden trap. This trap may be sprung if you contribute money or other property to your corporation both before and after you receive your stock. In that case, some of your stock will cease qualifying under Section 1244.

For an example, let's suppose that in January, our editor contributes $10,000 in exchange for 100 shares of stock. If she liquidates the company and receives nothing in return, she can deduct the full amount of her loss, $10,000, against her current, past, or future ordinary income.

Let's now assume that in April, in a desperate attempt to save the company, she contributes another $2,000 without receiving any more stock. By a fairly complex formula, her second contribution will reduce the amount she can take later as an ordinary loss and will convert some of that loss to a capital loss. In other words, her ordinary loss will be less than the amount of her initial $10,000 contribution, and none of her $2,000 contribution will qualify under Section 1244.

Our editor could have avoided this result if her corporation had issued additional stock to her in exchange for her additional $2,000 contribution. With that kind of planning, she could then have deducted her entire $12,000 loss against her ordinary income, rather than being forced to deduct a portion of her loss against capital gains. Perhaps, she could then use the money that she saved in income taxes to help her start a new business.

Conclusion

Section 1244 offers an opportunity to cushion the blow of failure. However, proper planning is necessary to assure that you receive its full benefits.