Disposal of Small Business Stock

One tried-and-true method to protect yourself by obtaining bigger tax write-offs if the business venture does go sour is to purchase "small business stock." In order to take advantage of this important tax break, however, certain rules must be followed.

The sale of stock at a loss usually generates a capital loss, which can only be deducted in any particular year to the extent of capital gains, plus $3,000. Fortunately, Congress recognizes that investors in small corporations often run more of a risk of loss. As a result, the Internal Revenue Code permits an individual to deduct, as an ordinary loss, a loss from sale or exchange, or from worthlessness, of "small business stock" (more commonly called "Code Sec. 1244 stock") issued by a qualifying small business corporation. Unlike a capital loss, an ordinary loss may fully offset wage income, dividends, or similar "ordinary" income.

To qualify as stock entitled to an ordinary loss deduction (Section 1244 stock), stock must be issued by a domestic corporation that is a small business corporation at the beginning of the tax year in which the stock is issued. A corporation is a small business corporation if the total amount of cash and other property received by the corporation for stock, as a contribution to capital and as paid-in surplus, does not exceed $1 million. If this $1 million threshold is exceeded only a portion of the corporation's stock can qualify as Section 1244 stock.

In addition to being issued by a small business corporation, to prove that it is an active business rather than a quasi-holding company two other corporate-level tests must be met to qualify the stock as Section 1244 stock:

1. The small business corporation must have more than 50 percent of its aggregate receipts derived from noninvestment income; and
2. It must be largely an operating company deriving more than 50 percent of its gross receipts from actual nonpassive sources. Investment income for this purpose includes only gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

There are limits, however, to the tax advantages to setting up a business using Section 1244 stock. The maximum amount deductible as an ordinary loss in any one year is $50,000 ($100,000 on a joint return). Corporations, estates and trusts are ineligible for tax-favored treatment.

If you have any further questions about how "Section 1244" stock might benefit your particular tax situation, please do not hesitate to contact me. The rules are a bit complicated, but the benefits of qualifying for this special loss protection may prove significant.