PART IX: BAD DEBT AND WORTHLESS SECURITIES

8694. When can a taxpayer deduct losses sustained as a result of a bad debt? What is the difference between a business bad debt and a nonbusiness bad debt?

A bad debt is a specific obligation which can be deemed with reasonable certainty to have become totally or partially worthless. If this is the case, the creditor-taxpayer may be entitled to a deduction corresponding to the amount of the worthless debt.[1]

There are two kinds of bad debt deductions: (1) business bad debts and (2) nonbusiness bad debts. A business bad debt, as the name suggests, is a debt that is incurred in the conduct of the taxpayer's trade or business. A nonbusiness bad debt is defined, by exclusion, in IRC Section 166(d)(2) as a bad debt *other than* a debt (a) created in the conduct of the taxpayer's business[2] or (b) the loss from the worthlessness of which was incurred in the conduct of the taxpayer's trade or business.[3] The second exclusionary rule allows a taxpayer who was not the original creditor to claim a worthless debt that he acquired in the conduct of his business.

The classification as either a business or nonbusiness bad debt is important because only a business bad debt can be treated as a deduction from ordinary income, while nonbusiness bad debts receive a capital loss treatment.[4] Further, a taxpayer can claim a deduction for wholly or partially worthless business bad debts, while nonbusiness bad debts must be completely worthless for the deduction to be allowed (see Q 8697).[5]

Whether a debt is incurred in relation to a taxpayer's trade or business, so as to be classified as a business bad debt, is a question of fact.[6] In making the determination, it is important to note that a taxpayer is not restricted to one type of business and that there is no requirement that the loss be incurred in conducting the business in which the taxpayer spends the majority of taxpayer's time.[7]

A deduction for a loss sustained as the result of a bad debt will only be permitted in cases where there is a valid debt and a true debtor-creditor relationship (see Q 8695). Whether a valid debt or a true debtor-creditor relationship exists is also a question of fact.[8]

A bad debt deduction will not be allowed in a situation where the debt is secured by collateral and the creditor has foreclosed on the collateral due to nonpayment.[9]

1. Treas. Reg. §1.166-1.
2. IRC Sec. 166(d)(2)(A); Treas. Reg. §1.166-5(b)(1).
3. IRC Sec. 166(d)(2)(B); Treas. Reg. §1.166-5(b)(2).
4. IRC Sec. 166(a) and (d).
5. IRC Sec. 166(d)(1).
6. *Commissioner v Smith*, 203 F.2d 310 (1953), *Nicholson v Commissioner*, 218 F.2d 240 (1954).
7. *Gliptis v United States*, 120 F. Supp. 3 (1954).
8. *Leuthold v. Commissioner*, 54 TCM 1308 (1987); *Lane v. United States*, 83-2 USTC 9524 (1983).
9. *Rose v Commissioner*, TC Memo 1987-19.

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Bad debts of corporations, except for S corporations, are always classified as business bad debts.[1] An S corporation is required to separately state its nonbusiness bad debt, which is taxed under the rules applicable to short-term capital losses (see Q 8589).[2]

A discharge of one's obligation as a guarantor is considered a nonbusiness bad debt. The loss sustained by a guarantor unable to recover from the debtor is by its very nature a loss from a bad debt to which the guarantor becomes subrogated upon discharging his liability as guarantor.[3]

If the debt fails to qualify as a business bad debt, it can, in many cases, be treated as a non-business bad debt.[4] If the taxpayer fails to establish that a debt qualifies as a business bad debt under IRC Section 166, he must be satisfied with treatment as a non-business bad debt under that same section and may not look to IRC Section 165 (see Q 8699) for an alternative means of treating loss on the debt as an ordinary loss deduction.[5]

8695. When is a taxpayer entitled to claim a bad debt deduction?

A taxpayer may claim a bad debt deduction (whether it is a business bad debt or a non-business bad debt, see Q 8694) for debt owed when the debt is a bona fide debt that has become worthless.[6]

A "bona fide debt" is one that arises from a creditor-debtor relationship involving a valid and enforceable agreement to pay a specific sum of money.[7] An agreement is considered to be a valid and enforceable agreement if it includes an unconditional promise by a debtor to pay the creditor.[8]

A taxpayer's voluntary undertaking to pay another debtor's obligations does not give rise to a valid and enforceable agreement for this purpose. Despite this, if the taxpayer volunteers to pay another person's obligation for a business purpose, and that debt subsequently becomes worthless, the taxpayer may be entitled to deduct the amount of the loss as a business expense under IRC Section 162.[9]

A bad debt can arise under a contractual agreement to pay a specific sum of money[10] or under an obligation created by law.[11] The requirements for determining whether a bad debt exists must be strictly met in order for the taxpayer to be entitled to claim the deduction.[12]

1. IRS Publication 535.
2. See Rev. Rul. 93-36; 1993-1 CB 187, Treas. Reg. §301.7701-2.
3. *Putnam v Commissioner*, 352 US 82 (1956).
4. See *Krasnow v United States*, 508 F. Supp. 1099 (1981).
5. *Alsobrook v. United States*, 431 F. Supp. 1122 (E.D. Ark.), aff'd 566 F. 2d 628 (6th Circuit 1977).
6. *Anderson v. Commissioner*, 5 TC 482 (1945), aff'd, 156 F.2d 591 (1946).
7. Treas. Reg. §1.166-1(c). See, also, *Kavanaugh v. United States*, 575 F. Supp. 41 (1983), *Hynard v. IRS*, 233 F. Supp.2d 502 (2002), *Schneider v. Commissioner*, 42 TCM 1449 (1981); *Edgar v. Commissioner*, 39 TCM 816 (1979), *Fryer v. Commissioner*, 33 TCM 403 (1974); *Holman v. Commissioner*, 32 TCM 1323 (1973).
8. *Wortham Mach. v. United States*, 521 F.2d 160 (1975).
9. *Lutz v. Commissioner*, 282 F.2d 614 (1960).
10. *Community Research and Dev. Corp. v. Commissioner*, TC Memo 1979-264.
11. See Rev. Rul. 72-505, 1972-2 CB 102, Rev. Rul. 69-458 1969-2 CB 33.
12. *Robinson-Davis Lumber Co. v Crooks*, 50 F.2d 638 (1931).

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Since it must be determined with reasonable certainty that the bad debt has become worthless, a bad debt deduction is typically not permitted if the creditor voluntarily forgives the debt.

A legal action is not required to establish that a debt is worthless or unrecoverable. Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action would in all probability not result in payment, a showing of these facts and circumstances will be sufficient evidence of the worthlessness of the debt.[1]

In determining whether a debt is worthless in whole or in part the IRS will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor.[2]

A taxpayer must make a reasonable inquiry, however, to ascertain whether the debt can be collected before claiming the bad debt deduction.[3]

~~**Practice Tip**~~**:** The parameters of what constitutes a "reasonable inquiry" into the collectability of a debt have certainly changed since the1938 court decision establishing that a "reasonable inference from information thus obtainable" satisfies the requirement [Footnote: *Freeman-Dent-Sullivan Co., Ibid.*] In today's digital age, apparently no less than a comprehensive credit check of the debtor and an assessment of economic conditions affecting the debtor's industry would likely suffice.

A bad debt deduction is claimed for the tax year in which the taxpayer determines that the debt is worthless, not in the year that the debt actually became worthless.[4] For example, if a debtor stopped making payments in 2013, but it was not until 2014 that the creditor-taxpayer determined that there was no reasonable chance that the debt would be paid, the bad debt deduction is properly claimed in 2014. A debtor's declaration of bankruptcy is generally treated as an indication that the debt has become at least partially worthless if the debt is unsecured and not a preferred debt.[5]

If a taxpayer finds that a debt is worthless, but later discovers that he may be able to recover all or a portion of the debt, the bad debt deduction is not invalidated.[6] Despite this, if a taxpayer has claimed a bad debt deduction, and subsequently finds that some amounts of the debt can be collected, the taxpayer is required to report any amounts collected on the debt as income.[7]

IRC Section 166(b) provides that the allowable deduction cannot exceed the creditor's basis in the debt as provided under Treasury Regulation Section 1.1011-1 (which outlines the rules for determining adjusted basis for purposes of calculating gain or loss). Though a taxpayer's basis in a debt may be equal to the face value of the debt, this is not always the case. The regulations identify certain situations where the deduction will not equal the face value of the debt

1. Treas. Reg. §1.166-2(b).
2. Treas. Reg. 1.662-2(a)
3. See *Freeman-Dent-Sullivan Co. v United States*, 21 F. Supp. 972 (1938).
4. See *Courier Journal Job Printing Co. v Glenn*, 37 F. Supp. 55 (1941).
5. Treas. Reg. §1.166-2(c).
6. See *Hamlen v Welch*, 116 F.2d 413 (1940).
7. Treas. Reg. §1.166-1(f).

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(for instance, the deduction for worthless receivables is based on the price paid by the purchaser of the receivables and not on their face value).[1]

8696. What accounting methods are available for a taxpayer to use in accounting for bad debts?

Because the Tax Reform Act of 1986 repealed the reserve method of accounting for most taxpayers,[2] all taxpayers, except for certain financial institutions, must use the specific charge-off method in accounting for bad debts. Financial institutions may still be permitted to use the reserve method in accounting for bad debts.

Under the specific charge-off method, the taxpayer deducts amounts that were charged off on its books during the tax year in question. To "charge-off" an item, a taxpayer can use any method that shows the intent to remove the debt as an asset.[3] The taxpayer must be the creditor both at the time that the worthlessness was determined *and* at the time the debt was charged-off[4] (to allow otherwise would permit the taxpayer to claim a deduction for a loss that he did not own).

A debt that is "significantly modified" is deemed charged off.[5] A *modification* means any alteration of a lender's or borrower's legal rights or obligations, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. A modification includes any total or partial deletion or addition to such rights or obligations, but excludes an alteration that occurs by operation of the terms of a debt instrument (i.e., the annual resetting of an interest rate). As a general rule, a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.[6] Treasury Regulation Section 1.1001-3(e)-(f) provides rules for determining when specific modifications are significant.[7]

The taxpayer must file a statement of facts substantiating the deduction along with the tax return containing the claim for the bad debt deduction.[8]

Financial institutions are also entitled to use the reserve method to account for losses resulting from bad debts. Instead of deducting specific bad debts from gross income, a financial institution can choose to deduct a reasonable amount as a reserve for bad debts. An account must be maintained for the bad debt reserves.[9] The reasonableness of the amount claimed is a question of fact. Factors that are often considered in making the reasonableness determination include the type of business involved and the amount of the bad debt.[10] What is reasonable in one business can vary from that which is reasonable for another business or in a different geographical area.

1. Treas. Reg. §1.166-1(d)(2)(i)(b).
2. P.L. 99-514, §805(a).
3. *Rubinkam v Commissioner*, 118 F.2d 148 (1941).
4. *Wachovia Bank & Trust Co. v United States*, 288 F.2d 750 (1961).
5. Treas. Regs. §§1.166-3(3) and 1.1001-3 (definition of significantly modified debt).
6. Treas. Reg. 1.1001-3(e)(1).
7. Treas. Reg. §1.1001-3(c).
8. Treas. Reg. §1.166-1(b).
9. Treas. Reg. §1.166-4.
10. Treas. Reg. §1.166-4(b).

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In using the reserve method, the taxpayer must file a statement of facts in support of the claim for the bad debt deduction. The statement must contain the following information:

(1) the amount of charge sales or other business transactions for the year and the percentage of the reserve from these sales;

(2) the total amount of the business' notes and accounts receivable at both the beginning and at the end of the tax year;

(3) the amount of debts that has become wholly or partially worthless and the amounts charged against the reserve account; and

(4) how the additional amount to the reserve account was determined.[1]

Special rules apply to certain banks claiming bad debt deductions.[2]

If a claim for a bad debt deduction is disallowed during one tax year, but subsequently the debt actually does become worthless, the taxpayer has seven years to file a claim for refund for the year that the debt actually became worthless.[3] This extension applies both to losses claimed under the specific charge-off method and under the reserve method[4]. This extended period does *not* apply to partially worthless debt (see Q 8697).[5]

8697. Is a bad debt deduction permitted when a debt is only partially worthless?

Certain taxpayers are entitled to claim a deduction for business bad debts that become only partially worthless during the tax year.[6] The allowable deduction cannot exceed the amount of the debt charged-off (see Q 8696) during the tax year.[7] The taxpayer must be able to clearly show the portion of the debt that has become partially worthless and must also show that the entire debt did not become worthless during the taxable year.

Despite this, a taxpayer is not *required* to charge-off and deduct partially worthless debts each year. Taxpayers are permitted to delay the bad debt deduction until the year in which the debt has become completely worthless.

Planning Point: Though a taxpayer is not required to claim a bad debt deduction in years when the debt is only partially worthless, the taxpayer is not permitted to claim the deduction for tax years beginning after the year in which the debt becomes *completely* worthless.[8]

1. Treas. Reg. §1.166-4(c).
2. Treas. Reg. §1.166-4(d), See Treas. Regs. §§1.585-1 through 1.585-3.
3. IRC Sec. 6511(d)(1).
4. *Smith Elec. Co. v. United States*, 461 F.2d 790 (1972).
5. Treas. Reg. §301.6511(d)-1(c).
6. IRC Sec. 166(a)(2), Treas. Reg. §1.166-3.
7. Treas. Reg. §1.166-3(a)(2)(iii).
8. See IRS Publication 535.

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If a taxpayer chooses to claim the deduction for partial worthlessness, the taxpayer's deduction in the year in which the debt becomes completely worthless is limited to the remaining basis in the debt.[1]

Not all taxpayers can claim a bad debt deduction if the debt is only partially worthless. IRC Section 166(d)(1) prohibits taxpayers "other than a corporation" from claiming a deduction for partially worthless *nonbusiness* debts.

If a debtor and a creditor reach a compromise agreement pursuant to which the creditor agrees to accept a lesser amount than what is owed, it is arguable that a partially worthless debt would result. However, the IRS has consistently refused to grant a deduction for partially worthless debts resulting from compromise agreements and the courts have agreed with this position.[2]

8698. Is a bad debt deduction permitted when a loan made between related parties becomes worthless?

A bad debt deduction may still be allowed in situations where the bad debt results from a loan made between related parties. The analysis of whether a worthless loan made between related parties gives rise to an allowable bad debt deduction is not the same as the analysis undertaken under IRC Section 267, however, which disallows certain losses on sales between related parties.[3]

Intrafamily transactions are subject to rigid scrutiny, and transfers from husband to wife are presumed to be gifts. However, this presumption may be rebutted by an affirmative showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness.[4]

The relevant inquiry in the bad debt context is whether the transaction was a valid loan or was instead a gift made between related parties. In making the determination, the courts examine all of the relevant facts and circumstances of the specific case.[5]

In connection with this facts and circumstances inquiry, it is important that both parties must intend and agree to treat the transaction as a loan, rather than as a disguised gift. Proper documentation of the transaction, while not strictly required, is helpful in proving the parties' intentions.[6] Regardless of whether the loan would have been extended had the parties not been related, the deduction should be sustained if, at the time the loan is made, there is a true intention amongst the parties that the debt will eventually be repaid.[7] See also Treasury Regulation Section 1.262-1(c)(4), which cites the IRC Section 166 bad debt deduction as one deduction that may be allowable despite the personal nature of the transaction.

1. IRC Sec. 166(b) and Treas. Reg. §1.166-3(a)(2)(iii), (b).
2. *Raffold Process Corp. v. Comm.*, 153 F.2d 168 (1946); *Bingham v. Comm.*, 105 F.2d 971 (1939); *Haskel v. Comm.*, TC Memo 1980-243. See *D'Alonzo v.Comm.*, 10 TCM 817 (1951); *Bohn v. Comm.*, 43 BTA 953 (1941).
3. See IRC Sec. 267 (disallowing certain losses on property sales and exchanges between related parties).
4. *Van Anda Est. v. Comm.* (1949), aff'd per curiam, 192 F. 2d 391(2nd Circuit 1951)
5. *Van Anda Est. v. Comm.*, 12 TC 1158, Ibid.,; *Mercil v.Comm.*, 24 TC 1150 (1955).
6. *Caligiuri v. Comm.*, 549 F.2d 1155 (8th Cir. 1977), aff'g TC Memo 1975-319. See also *Mellen v. Comm.*, TC Memo 1968-94, and *Cole v. Comm.*, TC Memo 1954-224.
7. *Oatman v. Comm.*, TC Memo 1982-684.

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Planning Point: In the context of related-party transactions, it is important to note that the worthless debt will likely be classified as a nonbusiness debt. Completely worthless nonbusiness bad debts can only be claimed as short-term capital losses (see Q 8567).[1]

8699. When is a deduction permitted if a taxpayer owns securities that become worthless?

While IRC Section 166 does not apply to worthless securities,[2] IRC Section 165 allows a deduction for losses incurred based on ownership of securities that have become completely worthless during the year. The term "security" for purposes of IRC Section 165 includes shares of stock, stock rights or evidence of indebtedness issued by a corporation or a government.[3] The worthlessness of the security is a question of fact[4] and the loss will be disallowed unless the taxpayer is able to furnish proof of the original cost of the security.[5]

There are no fixed rules that apply when determining whether a security is completely worthless. The taxpayer is required to make a reasonable inquiry, and what is reasonable here is based on the inquiry that a reasonable person would make in order to determine the worthlessness of the securities.[6] Worthlessness must be determined objectively.[7]

The securities do not have to be sold to establish worthlessness,[8] but it is insufficient to show that the securities would have no value if sold.[9] Diminution in value is also not enough to establish worthlessness.[10]

Worthless securities also include securities that the taxpayer abandons after March 12, 2008. To abandon a security, all rights in the security must be permanently surrendered and relinquished and no consideration received in exchange for the security. All the facts and circumstances determine whether the transaction is properly characterized as an abandonment or other type of transaction, such as an actual sale or exchange, contribution to capital, dividend, or gift.[11]

Instead, the worthlessness of securities is generally established by a showing that an identifiable event (or series of events)[12] occurred, and that it is reasonably certain the event (or events) rendered the securities completely worthless. An identifiable event has been judicially defined as "... an incident or occurrence that points to or indicates a loss-an evidence of a loss. The evidence, though, may vary according to circumstances and conditions."[13] The Board of Tax Appeals also defined identifiable events as "... such events as would clearly evidence to the person of average

1. See Form 8949, Sales and Other Dispositions of Capital Assets; see also IRS Publication 550.
2. IRC Secs. 166(e), 165(g)(2)(C), Treas. Reg. §1.166-1(g).
3. IRC Sec. 165(g)(2); Treas. Reg. §1.165-5(a).
4. *Coyle v. Comm.*, 142 F.2d 580 (1944); *Superior Coal Co. v. Comm.*, 145 F.2d 597 (1944).
5. *Jankowsky v. Comm.*, 56 F.2d 1006 (1932).
6. *Green v. Comm.*, 133 F.2d 76 (1943).
7. *Beaudry v. Comm.*, 150 F.2d 20 (1945).
8. *De Loss v. Comm.*, 28 F.2d 803 (1928); *Peyser v. United States*, 58 F Supp 331 (1944); *Moyer v. Comm.*, 35 BTA 1155 (1937).
9. *Bullard v. United States*, 146 F.2d 386 (1944).
10. *Wyoming Inv. Co. v. Comm.*, 70 F.2d 191 (1934).
11. IRS Pub. 550, Investment Income and Expense (2013).
12. *Rosing v. Corwin*, 88 F.2d 415 (1937).
13. *Industrial Rayon Corporation v. Comm.*, 94 F.2d 383 (1938).

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intelligence, under the circumstances, that no probability of realization of anything of value from this investment, by sale, liquidation, or otherwise, thereafter existed."[1] The identifiable event may be an actual cancellation of the debt or it may be an event the applicable entity is required, solely for purposes of reporting to the IRS, to treat as a cancellation of debt.[2]

8700. Is a loss sustained as a result of worthless securities treated as an ordinary loss or a capital loss?

Generally, securities are classified as capital assets and any loss resulting from their disposal will receive a capital loss treatment.[3] As a capital loss, the loss is considered to have occurred on the last day of the taxable year, which may allow the conversion of a loss that otherwise would have been treated as short-term loss into long-term loss (see Q 8567 and Q 8689 for a discussion of capital loss treatment and the holding period requirement).[4]

Despite this, IRC Section 165(g)(3) allows domestic corporate taxpayers to treat losses sustained on worthless securities as ordinary losses if an affiliated corporation issued the securities. An "affiliated corporation" is one that meets the following ownership test:

(1) the corporate taxpayer owns at least 80 percent of the voting stock and value of the corporation;[5] and

(2) more than 90 percent of the affiliated corporation's aggregate gross receipts for all taxable years has been derived from sources other than royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stock and securities.

If the taxpayer is a bank which directly owns at least 80 percent of the stock of another bank, the stock will not be treated as a capital asset. Hence, any loss incurred on disposition of these stocks will be treated as ordinary loss.[6]

See Q 8701 for the special treatment of losses sustained upon the sale of certain small business stock.

8701. What special rules apply to the deductibility of losses incurred on small business stock?

Generally, shareholders will receive either a capital gain or loss from the sale or disposition of their stock (see Q 8700). However, the taxpayer treats the loss as an ordinary loss if it results from the disposition of certain small business stock under IRC Section 1244.[7] The loss could either arise from the sale of the small business stock, or from a determination that the stock is worthless. This ordinary loss treatment is applicable for both common and preferred stock.

1. *John H. Watson, Jr.*, 38 BTA 1026 (1938).
2. IRS Pub. 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments (2013).
3. IRC 165(g).
4. Treas. Reg. §1.165-5(c).
5. IRC Sec 1504(a)(2).
6. See IRC Secs. 165(m)(1) and 582(b).
7. Treas. Reg. §1.1244(a)-1.

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Even though an individual may be entitled to ordinary loss treatment upon the sale of Section 1244 stock, the section does not apply to gains. Therefore, if a taxpayer realizes *gain* on the sale of Section 1244 stock, the gain is treated as a capital gain.

In a taxable year, the maximum amount of ordinary loss that can be claimed by a taxpayer under these provisions is $50,000 (or $100,000 for a married couple filing a joint tax return).[1] Any excess is treated as capital loss (see Q 8575 for a detailed explanation of the treatment of capital losses).

Stock in a domestic corporation is considered Section 1244 stock if the following requirements are met:[2]

(1) at the time the stock is issued, the corporation was a small business corporation (defined below);

(2) the stock was issued by the corporation in exchange for money or other property (excluding other stock and securities); and

(3) the corporation, during its five most recent tax years ending before the date the loss was sustained, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.[3]

A corporation qualifies as a small business corporation if the amount received by the corporation for stock does not exceed $1 million.[4]

Ordinary loss treatment is permissible if (1) the taxpayer was the shareholder to whom the stock of the small business corporation was issued and (2) the taxpayers are individual taxpayers who are partners in a partnership at the time the partnership acquired stocks in a small business corporation.[5]

Corporations (including S Corporations), trusts, and estates are not entitled to ordinary loss treatment under Section 1244 regardless of how the stock was acquired.[6] Individual taxpayers, other than the original holders of the stock, are also not entitled to ordinary loss treatment under Section 1244.[7] Stock is considered to have been issued once it has been fully paid for by the shareholder whether or not a certificate is prepared and delivered to the stockholder.[8]

Small business corporations should maintain adequate records to support any shareholder claims for ordinary loss treatment. The records should be sufficient to show:[9]

1. IRC Secs. 1244(b); 6013.
2. IRC Sec.1244(c)(1); Treas. Reg. §1.1244(c)-1.
3. See *Snedeker v. Comm.*, TC Memo 1983-675.
4. IRC Sec.1244(c)(3); Treas. Reg. §1.1244(c)-2.
5. Treas. Reg. §1.1244(a) 1(b).
6. See *Rath v. Comm.*, 101 TC 196 (1993).
7. *Rath v. Comm.*, above.
8. *Oppenheim v. Comm.*, TC Memo 1973-12; *Wesley H. Morgan*, 46 TC 878 (1966).
9. Treas. Reg. §1.1244(e)-1 (a)(2).

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(1) the persons to whom stock was issued, the date of issuance to these persons, and a description of the amount and type of consideration received from each;

(2) If the consideration received is property, the basis in the hands of the shareholder and the fair market value of the property when received by the corporation;

(3) The amount of money and the basis in the hands of the corporation of other property received for its stock, as a contribution to capital, and as paid-in surplus;

(4) Financial statements of the corporation, such as its income tax returns, that identify the source of the gross receipts of the corporation for the period consisting of the five most recent taxable years of the corporation, or, if the corporation has not been in existence for five taxable years, for the period of the corporation's existence; and

(5) Information relating to any tax-free stock dividend made with respect to Section 1244 stock and any reorganization in which stock is transferred by the corporation in exchange for Section 1244 stock.

In addition, a person who owns Section 1244 stock in a corporation must maintain records sufficient to distinguish such stock from any other stock he or she may own in the corporation.[1]

1. Treas. Reg. 1244(e)-1(b).

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