issuance of stock options, stock rights, or stock warrants at any time during the period of the plan, that are exercisable on stock other than stock offered under the plan, is considered a subsequent offering. Similarly, the issuance of pre-November 1978 stock other than that offered under the plan is considered a subsequent offering. Because stock issued upon exercise of a converson privilege is stock issued for a security, and stock issued under a stock option granted in whole or in part for services is not issued for money or other property, the issuance of securities with a conversion privilege and the issuance of such a stock option are subsequent offerings, because the conversion privilege and the stock option are exercisable with respect to stock other than that which may properly be offered under the plan. Pre-November 1978 stock issued under the plan before a subsequent offering is not disqualified because of the subsequent offering. The rule of the subparagraph, together with the rule of subparagraph (2) of this paragraph (f), relating to offers prior to the adoption of the plan, limits pre-November 1978 section 1244 stock to stock issued by the corporation during a period when any stock issued by it must have been issued under the plan.

(ii) Any modification of a plan that changes the offering to include preferred stock, or that increases the amount of pre-November 1978 stock that may be issued under the plan to such an extent that the requirements of paragraph (c) of this section would not have been satisfied if determined with reference to this amount as of the date the plan was initially adopted, or that extends the period of time during which stock may be issued under the plan to more than 2 years from the date the plan was initially adopted, is considered a subsequent offering, and no stock issued after this offering may qualify. However, a corporation may withdraw a plan and adopt a new plan to issue stock. To determine whether stock issued under this new plan may qualify, this paragraph (f) must be applied with respect to the new plan as of the date of its adoption. For example, amounts received for stock under the prior plan must be taken into account in determining whether the statutory requirements relating to definition of small business corporation are satisfied. In applying the requirements of paragraph (c) of this section, reference should be made to equity capital as of the date the new plan is adopted. The same principles apply if the period of the initial plan expires and the corporation adopts a new plan.

[T.D. 7779, 46 FR 29468, June 2, 1981]

§ 1.1244(c)–2 Small business corporation defined.

(a) *In general.* A corporation is treated as a small business corporation if it is a domestic corporation that satisfies the requirements described in paragraph (b) or (c) of this section. The requirements of paragraph (b) of this section apply if a loss is sustained on post-November 1978 stock. The requirements of paragraph (c) of this section apply if a loss is sustained on pre-November 1978 stock. If losses are sustained on both pre-November 1978 stock and post-November 1978 stock in the same taxable year, the requirements of paragraph (b) of this section are applied to the corporation at the time of the issuance of the stock (as required by paragraph (b) in the case of a loss on post-November 1978 stock) in order to determine whether the loss on post-November 1978 stock qualifies as a section 1244 loss, and the requirements of paragraph (c) of this section are applied to the corporation at the time of the adoption of the plan (as required by paragraph (c) in the case of a loss on pre-November 1978 stock) in order to determine whether the loss on pre-November 1978 stock qualifies as a section 1244 loss. For definition of domestic corporation, see section 7701 (a)(4) and the regulations under that section.

(b) *Post-November 1978 stock*—(1) *Amount received by corporation for stock.* Capital receipts of a small business corporation may not exceed $1,000,000. For purposes of this paragraph the term *capital receipts* means the aggregate dollar amount received by the corporation for its stock, as a contribution to capital, and as paid-in surplus. If the $1,000,000 limitation is exceeded, the rules of subparagraph (2) of this paragraph (b) apply. In making these determinations, (i) property is taken into account at its adjusted basis to the corporation (for determining gain) as of the date received by the corporation, and (ii) this aggregate amount is reduced by the amount of any liability to which the property was subject and by the amount of any liability assumed by the corporation at the time the property was received. Capital receipts are not reduced by distributions to shareholders, even though the distributions may be capital distributions.

(2) *Requirement of designation in event $1,000,000 limitation exceeded.* (i) If capital receipts exceed $1,000,000, the corporation shall designate as section 1244 stock certain shares of post-November 1978 common stock issued for money or other property in the transitional year. For purposes of this paragraph, the term *transitional year* means the first taxable year in which capital receipts exceed $1,000,000 and in which the corporation issues stock. This designation shall be made in accordance with the rules of subdivision (iii) of this paragraph (b)(2). The amount received for designated stock shall not exceed $1,000,000 less amounts received—

(A) In exchange for stock in years prior to the transitional year;

(B) As contributions to capital in years prior to the transitional year; and

(C) As paid-in surplus in years prior to the transitional year.

(ii) Post-November 1978 common stock issued for money or other property before the transitional year qualifies as section 1244 stock without affirmative designation by the corporation. Post-November 1978 common stock issued after the transitional year does not qualify as section 1244 stock.

(iii) The corporation shall make the designation required by subdivision (i) of this paragraph (b)(2) not later than the 15th day of the third month following the close of the transitional year. However, in the case of post-November 1978 common stock issued on or before June 2, 1981 the corporation shall make the required designation by August 3, 1981 or by the 15th day of the 3rd month following the close of the transitional year, whichever is later. The designation shall be made by entering the numbers of the qualifying share certificates on the corporation's records. If the shares do not bear serial numbers or other identifying numbers or letters, or are not represented by share certificates, the corporation shall make an alternative designation in writing at the time of issuance, or, in the case of post-November 1978 common stock issued on or before June 2, 1981 by August 3, 1981. This alternative designation may be made in any manner sufficient to identify the shares qualifying for section 1244 treatment. If the corporation fails to make a designation by share certificate number or an alternative written designation as described, the rules of subparagraph (3) of this paragraph (b) apply.

(3) *Allocation of section 1244 benefit in event corporation fails to designate qualifying shares.* If a corporation issues post-November 1978 stock in the transitional year and fails to designate certain shares of post-November 1978 common stock as section 1244 stock in accordance with the rules of subparagraph (2) of this paragraph (b), the following rules apply:

(i) Section 1244 treatment is extended to losses sustained on post-November 1978 common stock issued for money or other property in taxable years before the transitional year and is withheld from losses sustained on post-November 1978 stock issued in taxable years after the transitional year.

(ii) Post-1958 capital received before the transitional year is subtracted from $1,000,000.

iii) Subject to the annual limitation described in §1.1244(b)–1, an ordinary loss on post-November 1978 common stock issued for money or other property in the transitional year is allowed in an amount which bears the same ratio to the total loss sustained by the individual as:

(A) The amount described in §1.1244(c)–2(b) (3) (ii) bears to

(B) The total amount of money and other property received by the corporation in exchange for stock, as a contribution to capital, and as paid-in surplus in the transitional year.

(4) *Examples.* The provisions of this paragraph (b) may be illustrated by the following examples:

Example 1. On December 1, 1978, Corporation W, a newly-formed corporation, issues 10,000 shares of common stock at $125 a share for an amount (determined under subparagraph (1) of this paragraph (b)) of money and other property totaling $1,250,000. The board of directors specifies that 8,000 shares are section 1244 stock and records the certificate numbers of the qualifying shares in its minutes. Because Corporation W issued post-November 1978 common stock in exchange for money and other property exceeding $1,000,000, but has designated shares of stock as section 1244 stock and the designated shares were issued in exchange for money and other property not exceeding $1,000,000 (8,000 shares × $125 price per share = $1,000,000), the 8,000 designated shares qualify as section 1244 stock.

Example 2. Corporation X comes into existence on June 1, 1979. On June 10, 1979, Corporation X issues 2,500 shares of common stock at $250 per share to shareholder A and 2,500 shares of common stock at $250 per share to shareholder B. By written agreement dated September 1, 1981, shareholder A and shareholder B determine that 1,500 of shareholder A's shares and all of shareholder B's shares will be treated as section 1244 stock. Although shareholder A's 1,500 shares and shareholder B's 2,500 shares were issued for money and other property not exceeding $1,000,000 (4,000 shares × $250 price per share = $1,000,000, these 4,000 shares do not qualify as section 1244 stock under the rules of subparagraph (2) of this paragraph (b) for three reasons: The agreement of September 1, 1979, (i) did not identify which 1,500 of shareholder A's 2,500 shares were intended to qualify for section 1244 treatment, (ii) was made by the shareholders and not by Corporation X, and (iii) was made later than the 15th day of the third month following the close of the transitional year. However, certain of the shares issued by Corporation X may qualify as section 1244 stock under the rules of subparagraph (3) of this paragraph (b). See example (4).

Example 3. On December 1, 1980, Corporation Y issues common stock to shareholder A in exchange for $500,000 in cash. On August 1, 1981, Corporation Y issues common stock to shareholder B in exchange for property having an adjusted basis to Corporation Y of $500,000. On December 1, 1981, B transfers a tract of land having a basis in B's hands of $250,000 to Corporation Y as a contribution to capital. Under section 362(a)(2) of the Code, Corporation Y takes a basis of $250,000 in the tract of land. Corporation Y is a calendar year corporation. On February 15, 1982, it designates all of shareholder B's stock as section 1244 stock by entering the numbers of the qualifying certificates on the corporation's records. The designation made by Corporation Y is effective because it identifies which shares of its stock qualify for section 1244 treatment, was made in writing before the 15th day of the 3rd month following the close of the transitional year (1981), and because the amount received for designated stock does not exceed $1,000,000, less amounts received (i) in exchange for stock in years prior to the transitional year; (ii) as contributions to capital in years prior to the transitional year; and (iii) as paid-in surplus in years prior to the transitional year. Nevertheless, in the event of B's sale of his stock at a loss, the increase in basis attributable to his December, 1981, contribution to capital will be treated as allocable to stock that is not section 1244 stock under § 1.1244(d)–2.

Example 4. Corporation Z, a newly-formed corporation, issues 10,000 shares of common stock at $200 per share on July 1, 1979. In exchange for its stock Corporation Z receives property (other than stock or securities) having a basis to the corporation of $400,000, and $1,600,000 in cash, for a total of $2,000,000. Corporation Z fails to designate any of the issued shares as section 1244 stock. Shareholder C purchases 2,500 shares of the 10,000 shares of Corporation Z stock for $500,000 on July 1, 1979. Subsequently, shareholder C sells the 2,500 shares for $400,000. Shareholder C may treat $50,000 of the $100,000 loss as an ordinary loss under section 1244. The amount of that loss is computed under the rule of subparagraph (3) of this paragraph (b) as follows:

$$\frac{X \text{ [C's section 1244 loss]}}{\$100{,}000 \text{ [C's total loss]}} = \frac{\$1{,}000{,}000 \text{ [}\$1{,}000{,}000 - 0 = \$1{,}000{,}000\text{]}}{\$2{,}000{,}000 \text{ [total amount received by Corporation Z]}}$$

$$X = \$50{,}000$$

The remaining $50,000 is not treated as an ordinary loss under section 1244.

Example 5. (i) Corporation V, a newly-formed corporation, issues common stock to shareholder A and shareholder B on June 15, 1980, in exchange for $800,000 in cash ($400,000 from A and $400,000 from B). On September 15, 1981, the corporation issues common stock to shareholder C in exchange for $600,000 in cash. On January 1, 1982, common stock is issued to shareholder D in exchange for $100,000 in cash. Corporation V fails to designate any of the issued shares as section 1244 stock. A, B, C, and D subsequently sell their Corporation Y stock at a loss.

(ii) Subject to the annual limitation discussed in § 1.1244(b)–1, A and B may treat their entire loss as an ordinary loss under section 1244. D may not treat any part of his loss as an ordinary loss under section 1244. Subject to the annual limitation, one-third of the loss sustained by shareholder C is treated as an ordinary loss under section 1244. These results are calculated under the rules of subparagraph (3) of this paragraph (b) as follows: First, section 1244 treatment is extended to post-November 1978 stock issued to A and B in 1980, a taxable year before the transitional year (1981); section 1244 treatment is withheld from the stock issued to D in 1982, a taxable year after the transitional year. Second $800,000 the amount of post-1958 capital received in taxable years before the transitional year, is subtracted from $1,000,000 to leave $200,000. Third, subject to the annual limitation, an ordinary loss is allowed to C in an amount which bears the same ratio to his total loss as the amount calculated in the preceding sentence ($200,000) bears to the total amount received by the corporation in the transitional year in exchange for stock, as a contribution to capital, or as paid-in surplus ($600,000).

Example 6. Corporation V comes into existence on July 1, 1982. On that date it issues 10 shares of voting common stock to shareholder A in exchange for $500,000 and 5 shares of voting common stock to shareholder B in exchange for $250,000, designating the shares issued to both A and B as section 1244 stock. On September 15, 1982, Corporation V receives a contribution to capital from shareholders A and B having a basis in their hands of $225,000. On February 1, 1983, Corporation V issues one share of stock to shareholder C in exchange for $50,000. Corporation V may designate one-half of the share issued to shareholder C as section 1244 stock under §1.1244(c)–2 (b)(2). In 1982 the corporation received $750,000 for stock ($500,000 from A and $250,000 from B) and $225,000 as a capital contribution, totaling $975,000 in capital receipts. The receipt of $50,000 from shareholder C in exchange for stock in 1983 causes capital receipts to exceed $1,000,000 and 1983 thus becomes Corporation V's transitional year. Corporation V may receive only $25,000 for designated stock in 1983 under the rule set forth in §1.1244 (c)–2 (b)(2)(i), which states that the amount received for designated stock shall not exceed $1,000,000, less amounts received (i) in exchange for stock in years prior to the transitional year ($750,000 from A and B), (ii) as contributions to capital in years prior to the transitional year ($225,000), and (iii) as paid-in surplus in years prior to the transitional year ($0). Thus, one-half of C's share (representing the receipt of $25,000) may be designated as section 1244 stock by Corporation V. In the event of the sale of A's stock or B's stock at a loss, the increase in basis attributable to their contribution to capital will be treated as allocable to stock that is not section 1244 stock under §1.1244(d)–2.

(c) *Pre-November 1978 stock*—(1) *Amount received by corporation for stock.* At the time of the adoption of the plan, the sum of the aggregate dollar amount to be paid for pre-November 1978 stock that may be offered under the plan plus the aggregate amount of money and other property that has been received by the corporation after June 30, 1958, and on or before November 6, 1978, for its stock, as a contribution to capital by its shareholders, and as paid-in surplus must not exceed $500,000. In making these determinations (i) property is taken into account at its adjusted basis to the corporation (for determining gain) as of the date received by the corporation, and (ii) this aggregate amount is reduced by the amount of any liability to which the property was subject and by the amount of any liability assumed by the corporation at the time the property was received. For purposes of the $500,000 test, the total amount of money and other property received for stock, as a contribution to capital, and as paid-in surplus is not reduced by distributions to shareholders, even though the distributions may be capital distributions. Thus, once the total amount of money and other property received after June 30, 1958, reaches $500,000, the corporation is precluded from subsequently issuing pre-November 1978 stock. For a different rule that applies to post-November 1978 stock see §1.1244(c)–2(b).

(2) *Equity capital.* The sum of the aggregate dollar amount to be paid for pre-November 1978 stock that may be offered under the plan plus the equity capital of the corporation (determined on the date of the adoption of the plan) may not exceed $1,000,000. For this purpose, equity capital is the sum of the corporation's money and other property (in an amount equal to its adjusted basis for determining gain) less the amount of the corporation's indebtedness to persons other than its shareholders.

(3) *Examples.* The provisions of this paragraph (c) may be illustrated by the following examples:

Example 1. Corporation W comes into existence on December 1, 1958. On that date the corporation may adopt a plan to issue common stock for an amount (determined under subparagraph (1) of this paragraph (c)) not in excess of $500,000 during a period ending not later than November 30, 1960. Such corporation will qualify as a small business corporation as of the date that the plan is adopted. However, if the corporation adopts a plan to issue stock for an amount in excess of $500,000 it is not a small business corporation at the time the plan is adopted and no stock issued under the plan may qualify as section

1244 stock. If the cost of organizing corporation W amounted to $1,000 and constituted paid-in surplus or a contribution to capital, such amount must be taken into account in determining the amount that may be received under the plan, with the result that only $499,000 may be so received.

Example 2. On December 1, 1958, Corporation X, a newly formed corporation, adopts a plan to issue common stock for an amount (determined under subparagraph (1) of this paragraph (c)) not in excess of $500,000 during a period ending not later than November 30, 1960. By January 1, 1960, the corporation has, pursuant to the plan, issued at par, stock having an aggregate par value of $400,000, $200,000 of which was issued for $200,000 cash, and $200,000 of which was issued for property (other than stock or securities) having a basis to the corporation of $100,000 and a fair market value of $200,000. The corporation may, prior to November 30, 1960, issue stock for an amount not in excess of $200,000 cash or property having a basis to it not in excess of $200,000. Stock issued for any payment which, alone or together with any payments received after January 1, 1960, exceeds such $200,000 amount would not qualify as section 1244 stock because it would not be issued pursuant to the plan.

Example 3. Assume that on December 1, 1958, Corporation Y, a newly formed corporation, adopts a plan to issue common stock for an amount (determined under subparagraph (1) of this paragraph (c)) not in excess of $500,000 during a period ending not later than November 30, 1960. By January 1960 the corporation has received $400,000 cash for stock issued pursuant to the plan, but due to business successes the equity capital of the corporation exceeds $1,000,000. Since the equity capital test is made as of the date that the plan is adopted, the corporation may still, prior to November 30, 1960, issue section 1244 stock pursuant to the plan until the full amount specified in the plan has been received.

Example 4. Subsequent to June 30, 1958, Corporation Z receives a total of $600,000 cash on the issuance of its stock. In 1960 Corporation Z redeems shares of its stock for the total amount of $300,000 and the redemptions reduce Corporation Z's capital to substantially less than $500,000. Notwithstanding the redemptions, pre-November 1978 stock subsequently issued by Corporation Z will not qualify as section 1244 stock because the $500,000 limitation has been previously exceeded.

[T.D. 7779, 46 FR 29470, June 2, 1981, as amended by T.D. 7837, 47 FR 42729, Sept. 29, 1982; 60 FR 16575, Mar. 31, 1995]

§ 1.1244(d)–1 Contributions of property having basis in excess of value.

(a) *In general.* (1) Section 1244(d)(1)(A) provides a special rule which limits the amount of loss on section 1244 stock that may be treated as an ordinary loss. This rule applies only when section 1244 stock is issued by a corporation in exchange for property that, immediately before the exchange, has an adjusted basis (for determining loss) in excess of its fair market value. If section 1244 stock is issued in exchange for such property and the basis of such stock in the hands of the taxpayer is determined by reference to the basis of such property, then for purposes of section 1244, the basis of such stock shall be reduced by an amount equal to the excess, at the time of the exchange, of the adjusted basis of the property over its fair market value.

(2) The provisions of section 1244(d)(1)(A) do not affect the basis of stock for purposes other than section 1244. Such provisions are to be used only in determining the portion of the total loss sustained that may be treated as an ordinary loss pursuant to section 1244.

(b) *Transfer of more than one item.* If a taxpayer exchanges several items of property for stock in a single transaction so that the basis of the property transferred is allocated evenly among the shares of stock received, the computation under this section should be made by reference to the aggregate fair market value and the aggregate basis of the property transferred.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. B transfers property with an adjusted basis of $1,000 and a fair market value of $250 to a corporation for 10 shares of section 1244 stock in an exchange that qualifies under section 351. The basis of B's stock is $1,000 ($100 per share), but, solely for purposes of section 1244, the total basis of the stock must be reduced by $750, the excess of the adjusted basis of the property exchanged over its fair market value. Thus, the basis of such stock for purposes of section 1244 is $250 and the basis of each share for such purposes is $25. If B sells his 10 shares for $250, he will recognize a loss of $750, all of which must be treated as a capital loss. If he sells the 10 shares for $200, then $50 of his total loss of $800 will be treated as an ordinary loss under