**8551. Are there any special rules applicable in determining whether a gain or loss is long-term or short-term when a short sale is involved?**

Whether capital gain or loss on a short sale is long-term or short-term will ordinarily be determined by the seller’s holding period in the stock used to close the sale.[[1]](#footnote-1) For most purposes, the capital gain or loss is long-term if the holding period is more than one year. If the holding period is one year or less, the gain is short-term. (See Q 8550 for a detailed discussion of the holding period requirement.)

In a “short sale,” a seller agrees to sell stock to another at a fixed price on a future date. If the future date is more than a year from the date the taxpayer acquired the stock, he or she would be able to convert short-term capital gain (taxed at ordinary tax rates, i.e., up to 39.6%) as compared to long-term capital gain rates (i.e., 15% 0r 20%). IRC Sections 1233 and 1259 are designed to prevent such abuse.

*Example:* On March 1, 2013, Asher acquires stock for $200. On September 1, the fair market value of the stock is $300. To lock in the appreciation, Asher enters a short sale to close on April 1, 2014. Without IRC Sections 1233 and 1259, Asher would effectively convert a short-term holding period into a long-term holding period; and, thus, recognize long-term capital gain.

To prevent individuals from using short sales to convert short-term gains to long-term gains or long-term losses to short-term losses, and to prevent the creation of artificial losses, the IRC and regulations provide special rules as follows:

(1) If on the date the short sale is closed (see below), any “substantially identical property” has been held by the seller for a period of one year or less, any *gain* realized on property used to close the sale will, to the extent of the quantity of such substantially identical property, be *short-term* capital gain.[[2]](#footnote-2) This is true even though the stock actually used to close the short sale has been held by the seller for more than one year. This rule does not apply to *losses* realized on the property used to close the sale;

(2) If *any* substantially identical property is acquired by the seller after the short sale and on or before the date the sale is closed, any *gain* realized on property used to close the sale will, to the extent of the quantity of such substantially identical property, be *short-term* capital gain.[[3]](#footnote-3) This is true regardless of how long the substantially identical property has been held, how long the stock used to close the short sale has been held, and how much time has elapsed between the short sale and the date the sale is closed. This rule does not apply to *losses* realized on the property used to close the sale;

(3) The holding period of any substantially identical property held one year or less, or acquired after the short sale and on or before the date the short sale is closed will, to the extent of the quantity of stock sold short, be deemed to have begun on the date the sale is closed or the date such property is sold or otherwise disposed of, whichever is earlier. If the quantity of such substantially identical property held for one year or less or so acquired exceeds the quantity of stock sold short, the “renewed” holding period will normally be applied to individual units of such property in the order in which they were acquired (beginning with earliest acquisition), but only to so much of the property as does not exceed the quantity sold short. Any excess retains its original holding period.[[4]](#footnote-4) But where the short sale is entered into as part of an *arbitrage operation* in stocks or securities, this order of application is altered so that the “renewed” holding period will be applied first to substantially identical property acquired for arbitrage operations and held at the close of business on the day of the short sale and then in the order of acquisition as described in the previous sentence. The holding period of substantially identical property *not* acquired for arbitrage operations will be affected only to the extent that the quantity sold short exceeds the amount of substantially identical property acquired for arbitrage operations;[[5]](#footnote-5)

(4) If on the date of a short sale *any* substantially identical property has been held by the seller for more than one year, any *loss* realized on property used to close the sale will, to the extent of the quantity of such substantially identical property, be *long-term* capital loss.[[6]](#footnote-6) This is true even though the stock actually used to close the short sale has been held by the seller for a year or less. This rule does not apply to *gains* realized on the property used to close the sale.

1. . Treas. Reg. §1.1233-1(a)(3). See *Bingham*, 27 BTA 186 (1932), *acq.* 1933-1 CB 2. [↑](#footnote-ref-1)
2. . IRC Sec. 1233(b)(1); Treas. Reg. §1.1233-1(c). [↑](#footnote-ref-2)
3. . IRC Sec. 1233(b)(1); Treas. Reg. §1.1233-1(c). [↑](#footnote-ref-3)
4. . IRC Sec. 1233(b)(2); Treas. Reg. §1.1233-1(c)(2). [↑](#footnote-ref-4)
5. . IRC Sec. 1233(f); Treas. Reg. §1.1233-1(f). [↑](#footnote-ref-5)
6. . IRC Sec. 1233(d); Treas. Reg. §1.1233-1(c)(4). [↑](#footnote-ref-6)