PART II: CAPITAL GAINS AND LOSSES

8560. What is a "capital asset"?

Generally, any property held as an investment is a capital asset, except that rental real estate is typically not a capital asset because it is treated as a trade or business asset.[1]

The Code defines a "capital asset" by what it is not. So for purposes of determining whether a certain type of property is a capital asset, it cannot be any of the following types of property:

(1) property (including inventory and stock in trade) held primarily for sale to customers;

(2) real or depreciable property used in the taxpayer's trade or business;

(3) copyrights and literary, musical, or artistic compositions (or similar properties) created by the taxpayer, or merely owned by him, if the taxpayer's basis in the property is determined (other than by reason of IRC Section 1022, which governs the basis determination of inherited property) by reference to the creator's tax basis;

(4) letters, memoranda, and similar properties produced by or for the taxpayer, or owned by him if the taxpayer's basis is determined by reference to the tax basis of the producer or recipient;

(5) accounts or notes receivable acquired in the taxpayer's trade or business for services rendered or sales of property described in (1), above;

(6) certain publications of the United States government;

(7) any commodities derivative financial instrument held by a commodities derivatives dealer;

(8) any hedging instrument clearly identified as such by the required time; or

(9) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of the taxpayer's trade or business.[2]

8561. What are the current long-term capital gains tax rates?

In 2014, for long-term capital gain, adjusted net capital gain (see Q 8562) is generally subject to the following tax rates:

(1) 0 percent for taxpayers in the 10 and 15 percent tax brackets;

(2) 15 percent for taxpayers in the 25 percent, 28 percent, 33 percent and 35 percent tax brackets; and

(3) 20 percent for taxpayers in the 39.6 percent tax bracket.

1. See IRS Pub. 544.
2. IRC Sec. 1221; Treas. Reg. §1.1221-1.

However, detailed rules as to the exact calculation of the capital gains tax result in some exceptions. See Q 8562 (determining amount of capital gain), Q 8563 (Section 1250, Section 1202 and collectibles property) and Q 8567 (holding period requirement for determining whether gain is subject to long-term or short-term rates).[1]

See Q 8573 for an outline of the netting process used in determining capital gains and losses when multiple asset classes are involved.

Beginning in 2013, taxpayers with adjusted gross income in excess of certain thresholds may be subject to the 3.8 percent net investment income tax pursuant to Code Section 1411 (see Q 8579 to Q 8588). This 3.8 percent is a surtax added to the taxpayer's otherwise applicable tax rate.

8562. How is net capital gain taxed?

"*Net capital gain* is the excess of net long-term capital gain for the taxable year over net short-term capital loss for such year.[2] However, net capital gain for any taxable year is reduced (but not below zero) by any amount the taxpayer takes into account under the investment income exception to the investment interest deduction.[3]

If a taxpayer has net capital gain for any tax year, the IRC provides that the tax will not exceed the *sum* of the following six items:

(A) the tax computed at regular rates (without regard to the rules for capital gain) on the *greater* of (i) taxable income reduced by the net capital gain, or (ii) the *lesser* of (I) the amount of taxable income taxed at a rate below 25 percent, *or* (II) taxable income reduced by the adjusted net capital gain;

(B) 0 percent of the taxpayer's adjusted net capital gain (or, if less, taxable income) that does not exceed the *excess* (if any) of (i) the amount of taxable income that would (without regard to this paragraph) be taxed at a rate below 25 percent *over* (ii) the taxable income reduced by the adjusted net capital gain;

(C) 15 percent of the lesser of (i) so much of the taxpayer's adjusted net capital gain (or, if less, taxable income) as *exceeds* the amount on which a tax is determined under (B), above, or (ii) the *excess* of (I) the amount of taxable income which would be taxed at below 39.6 percent *over* (II) the sum of the amounts on which a tax is determined under (A) and (B), above;

(D) 20 percent of the taxpayer's adjusted net capital gain (or, if less, taxable income) in *excess* of the sum of the amounts on which tax is determined under (B) and (C), above;

(E) 25 percent of the *excess* (if any) of (i) the unrecaptured IRC Section 1250 gain (or, if less, the net capital gain (determined without regard to qualified dividend income)),

1. IRC Sec. 1(h), as amended by ATRA.
2. IRC Sec. 1222(11).
3. IRC Secs. 163(d)(4)(B)(iii), 1(h)(2).

over (ii) the *excess* (if any) of (I) the sum of the amount on which tax is determined under (A) above, *plus* the net capital gain, *over* (II) taxable income (See Q 8563 for a discussion of unrecaptured IRC Section 1250 gain); *and*

(F) 28 percent of the amount of taxable income in *excess* of the sum of the amounts on which tax is determined under (A) through (D) above. See Q 8563 for a discussion of 28 percent gain.

For most long-term capital gains, this complicated formula generally results in a maximum capital gains rate on adjusted net capital gain for 2014 equal to: (i) 20 percent for individuals taxed at the 39.6 percent income tax rate, (ii) 15 percent for individuals taxed at the 25, 28, 33 or 35 percent income tax rates, and (iii) 0 percent for individuals taxed at the 15 percent or 10 percent income tax rates.

8563. What rates apply to capital gains property classified as Section 1250 property, Section 1202 stock or collectibles?

Gain attributable to the sale or exchange of collectibles, IRC Section 1202 gain (i.e., qualified small business stock), and unrecaptured IRC Section 1250 gain are subject to different tax rates. Gain on the sale or exchange of collectibles and IRC Section 1202 property is taxed at 28 percent, and unrecaptured gain on IRC Section 1250 property is taxed at 25 percent.[1]

"Collectibles gain" is taxable gain on the sale or exchange of a collectible that is a capital asset held for more than one year[2] Examples of collectibles include artwork, gems and coins.[3]

"Section 1202 gain" is the gain on the sale or exchange of section 1202 stock. Pursuant to IRC Section 1202, an individual may exclude 50 percent of the taxable gain on the sale or exchange of "qualified small business stock" that is held for more than 5 years.

"Unrecaptured Section 1250 gain" is the portion of the gain on the sale or exchange of real property attributable to depreciation. Nonresidential real property (such as commercial buildings) and residential rental property (such as apartment buildings) are section 1250 property and are depreciated under the straight line method (i.e., the same amount of depreciation is taken every tax year).[4] Each year's depreciation reduces the basis of the real property by a like amount.[5] So when such real property is sold, the gain attributable to the basis reduction is considered unrecaptured Section 1250 gain.

> *Example*: Asher owns a commercial building with an original basis in the building of $500,000. After several years, when the basis of the building had been reduced to $350,000, Asher sells the building for $500,000. Even though the building did not appreciate, Asher has a gain of $150,000 ($500,000 minus $350,000), all of which is attributable to the depreciation reduction of basis. Such gain is considered to be unrecaptured Section 1250 gain.

1. IRC Sec. 1(h).
2. IRC Sec. 1(h)(5).
3. See IRC Sec. 408(m)(2).
4. IRC Sec. 168(b)(3)(A) and (B).
5. IRC Sec. 1016(a)(2).

8564. What new rules have been developed in the past years to change long-term capital gain rates?

Congress has taken steps in recent years to reduce the rates applicable to long-term capital gains. As such, long-term capital gains recognized on or after May 6, 2003 are subject to lower tax rates today than has historically been the case. For taxpayers in the 25, 28, 33 and 35 percent tax brackets with respect to ordinary income, the rate on long-term capital gains was reduced from 20 percent to 15 percent in 2003 through 2012. For taxpayers in the 10 and 15 percent brackets, the rate on long-term capital gains was reduced from 10 percent to 5 percent in 2003 through 2007, and then down to 0 percent in 2008 through 2012. As discussed below, these lower capital gain rates have been made permanent for tax years beginning after 2012.[1]

The American Taxpayer Relief Act of 2012 ("ATRA") extended the 0 percent and 15 percent capital gain rates for most taxpayers and increased the rates for taxpayers in the highest income tax bracket.

ATRA permanently increased the rate on long-term capital gains to 20 percent for taxpayers with taxable income exceeding an annual applicable threshold amount (for 2014, the threshold amount is $406,750 for single taxpayers, $457,600 for married taxpayers filing jointly, $432,200 for heads of households and $228,800 for married taxpayers filing separately and for 2013, the threshold amount was $400,000 for single taxpayers, $450,000 for married taxpayers filing jointly, $425,000 for heads of households, and $225,000 for married taxpayers filing separately). The applicable threshold amounts are adjusted annually for inflation.[2]

For taxpayers in the 10 or 15 percent income tax brackets, the rate on long-term capital gains is now permanently set at 0 percent. Taxpayers in the 25, 28, 33 and 35 percent tax brackets will continue to be taxed at 15 percent on long-term capital gains.[3]

In addition, beginning January 1, 2013, a new investment income tax of 3.8 percent applies to certain investment-type income (including income received from capital gains). The investment income tax applies for taxpayers whose annual adjusted gross income exceeds the investment income threshold amount ($250,000 for married taxpayers filing jointly, $125,000 for married taxpayers filing separately and $200,000 for all other taxpayers).[4] See Q 8579 to Q 8588 for a detailed discussion of the investment income tax.

The rates applicable for collectibles gain, IRC Section 1202 gain (i.e., qualified small business stock), and unrecaptured IRC Section 1250 gain have remained unchanged. See Q 8563.[5]

Repeal of qualified 5-year gain. For tax years beginning after December 31, 2000, if certain requirements were met, the maximum rates on "qualified 5-year gain" could be reduced to 8 percent and 18 percent (in place of 10 percent and 20 percent respectively). Furthermore,

1. IRC Sec. 1(h)(1), as amended by ATRA; TIPRA 2005 Sec. 102, *amending* JGTRRA 2003 Sec. 303.
2. IRC Secs. 1(i), 1(h), as amended by ATRA, Secs. 101(b)(3)(C) and 102(b); Rev. Proc. 2013-35, 2013-47 IRB 537.
3. IRC Sec. 1(h), as amended by ATRA, Sec. 102.
4. IRC Sec. 1411.
5. IRC Sec. 1(h).

a noncorporate taxpayer in the 25 percent bracket (or higher) who held a capital asset on January 1, 2001 could elect to treat the asset as if it had been sold and repurchased for its fair market value on January 1, 2001 (or on January 2, 2001 in the case of publicly traded stock). If a noncorporate taxpayer made this election, the holding period for the elected assets began after December 31, 2000, thereby making the asset eligible for the 18 percent rate if it was later sold after having been held by the taxpayer for more than five years from the date of the deemed sale and deemed reacquisition.[1] Under JGTRRA 2003, the 5-year holding period requirement, and the 18 percent and 8 percent tax rates for qualified 5-year gain, were repealed. Though this repeal was scheduled to sunset along with the reduced rates on long-term capital gains, it was made permanent under ATRA.

8565. What is "tax basis" and how is it used in determining the amount of a taxpayer's capital gain or loss?

"Tax basis" is a taxpayer's after tax investment in property. In other words, when a taxpayer acquires property for money, it is presumed to be his or her after tax investment in such property.[2] So when property is sold or exchanged, for purposes of computing gain, the difference between the amount received less the taxpayer's basis in the property is the taxable gain.[3] Similarly, for purposes of computing a loss (meaning the taxpayer received less than its original cost), the difference between the taxpayer's basis in the property and the amount received is the taxable loss.[4]

> *Example*: In 2012, Asher purchased Apple stock for $1,000. In 2014, Asher sold the stock for $1,500. Asher's taxable gain is $500, or the difference the amount received and his basis in the stock ($1,500 minus $1,000). Obviously, there would be no tax on the $1,000 received because it would simply be the recovery of Asher's initial after tax investment in the property, i.e., his basis.
>
> In the alternative, if Asher sold the Apple stock for $500, his taxable loss would be $500, or the difference between his basis in the stock (what he paid for it) and what he received in the sale ($1,000 minus $500). In this case, Asher has a loss because the amount he received is less than what he originally paid.

If the taxpayer acquires property other than by purchase, basis is determined pursuant to different rules. For example, if the taxpayer acquires property from a decedent by inheritance or bequest, the basis in the property is its date of death fair market value.[5]

With respect to the gift of property, the general rule is the donee taxpayer takes the donor's basis in the property.[6]

> *Example*: Asher gifts Apple stock he purchased for $1,000 to his friend Ashley. At the time of the gift, the stock had a fair market value of $1,500. Ashley's basis in the stock is $1,000, the same as Asher's. So if she sold the stock for $1500, she would have a $500 gain.

1. IRC Secs. 1(h)(2), 1(h)(9), prior to amendment by JGTRRA 2003; JCWAA 2002 Sec. 414(a) and CRTRA 2000 Sec. 314(c), amending TRA '97 Sec. 311(e).
2. IRC Sec. 1012.
3. IRC Sec. 1001(a).
4. IRC Sec. 1001(a).
5. IRC Sec. 1014.
6. IRC Sec. 1015(a).

On the other hand, there is an exception to the rule that the donee taxpayer takes the donor's basis in the property. This occurs when at the time of the gift, the donor's basis is greater than the fair market value of the gifted property. In that case, the donee taxpayer's basis is the fair market value of the property.[1]

Example: Asher gifts Apple stock he purchased for $1,000 to his friend Ashley. At the time of the gift, the stock had a fair market value of $500. Because Asher's basis of $1,000 is greater than its $500 fair market value, Ashley's basis in the stock is $500. So if she sold the stock for $500, she would have no gain or loss. The reason for this rule to prevent one taxpayer to shift a taxable loss to the other taxpayer. If Ashley had taken Asher's $1,000 basis, she would have reported a $500 loss rather than Asher.

8566. How is tax basis adjusted and what affect does it have in the computation of capital gain or loss?

As discussed in Q 8565, gain or loss is measured by determining whether the amount received in exchange for property was more or less than the taxpayer's "basis." If the amount received is more than basis, there is a taxable gain. Conversely, if basis is greater than the amount received there is a taxable loss. However, during the taxpayer's ownership of property, certain adjustments to the original tax basis are required. Thus, tax basis as adjusted is referred to as "adjusted basis."

In the course of a taxpayer's ownership of property, basis can be increased or it can be decreased.

Capital Improvement

Example: Asher purchases a 10 story office building for $500,000. Subsequently, Asher decides to add an 11th story to the building at a cost of $100,000. As a capital improvement, Asher's original $500,000 basis is adjusted upward to $600,000[2] and becomes the adjusted basis in the building.

Depreciation

Broadly described, depreciation is a means of deducting the cost of an asset over its useful life. For example, the cost of a commercial building (excluding the land which is non-depreciable) is depreciated over 39 years.[3] Based on a tax fiction, at the end of the 39 year depreciation period, the building will be completely "used up" and worth nothing. So every year, the basis of the building is adjusted downward by the amount of that year's depreciation deduction.[4]

Example: Asher purchases a 10 story office building for $390,000.[5] Because the building is depreciable over 39 years, each year Asher claims a $10,000 depreciation deduction. So after 9 years, Asher's original basis is adjusted downward to $300,000 ($390,000 minus $90,000). So, if at time Asher were to sell the building for $400,000, he would have a taxable gain of $100,000 ($400,000 minus $300,000).

1. IRC Sec. 1015(a).
2. IRC Sec. 1016(a)(1).
3. IRC Sec. 168(c).
4. IRC Sec. 1016(a)(2).
5. For purposes of this example, the amount of the purchase price attributable to the land is ignored.

8567. What is the "holding period" for long-term and short-term capital gain; and how is the holding period calculated?

Whether a capital gain or loss is long-term or short-term is determined by how long the taxpayer owned the property in question. Generally, a capital gain or loss is long-term if the property giving rise to the gain or loss was owned *for more than one year* and short-term if the property was owned for *one year or less*.[1]

To determine how long a taxpayer has owned property (i.e., the "holding period"), the taxpayer must begin counting on the day *after* the property is acquired. For these purposes, the same date in each successive month is considered to be the first day of a new month. The date on which the property is disposed of is included (i.e., counted) in the holding period.[2]

If property is acquired on the last day of the month, the holding period begins on the first day of the following month. Therefore, if it is sold prior to the first day of the 13th month following the acquisition, the gain or loss will be short-term.[3] According to IRS Publication 544 (published in November 1982), if property is acquired *near* the end of the month and the holding period begins on a date that does not occur in every month (e.g., the 29th, 30th, or 31st), the last day of each month that lacks that date is considered to begin a new month (however, later editions of Pub. 544 have omitted this statement).

Example 1: Mrs. Murphy bought a capital asset on January 1, 2014. She would begin counting on January 2, 2014. The 2nd day of each successive month would begin a new month. If Mrs. Murphy sold the asset on January 1, 2015, her holding period would not be more than one year. To have a long-term capital gain or loss she would have to sell the asset on or after January 2, 2015.

Example 2: Mrs. Tate bought a capital asset on January 30, 2014. She would begin counting on January 31, 2014. Since February does not have 31 days, Mrs. Tate will start a new month on February 28. In months that have only 30 days, the 30th will begin a new month.

In some cases, such as when property is received as a gift or in a like-kind exchange, the IRC allows for the "tacking" of a holding period meaning that the holding period of a previous owner of the property carries over to the new owner or the holding period of an asset exchanged for another carries over to the exchanged property.[4]

Example: Abe buys 500 shares of XYZ Corp. stock for $7,500, on December 4, 2013. On September 20, 2014, Abe transfers the stock to his daughter, Diana, as a gift. On December 20, 2014, Diana sells the stock for $9,000. Even though Diana actually owned the stock for ~~for~~ more than a year, by application of the "tacking" rule, the holding period begins on December 4, 2013, the date the stock was purchased by Abe. Additionally, Diana assumes Abe's $7,500 basis in the stock. So upon the sale, Diana has a $1,500 long-term capital gain ($9,000 minus $7,500).

1. IRC Sec. 1222.
2. Rev. Rul. 70-598, 1970-2 CB 168.
3. Rev. Rul. 66-7, 1966-1 CB 188.
4. IRC Sec. 1223.

8568. 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] 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 8567 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 percent) as compared to long-term capital gain rates (i.e., 15 percent 0r 20 percent). 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] 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] 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

1. Treas. Reg. §1.1233-1(a)(3). See *Bingham*, 27 BTA 186 (1932), *acq*. 1933-1 CB 2.
2. IRC Sec. 1233(b)(1); Treas. Reg. §1.1233-1(c).
3. IRC Sec. 1233(b)(1); Treas. Reg. §1.1233-1(c).

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.[1] 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;[2]

(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.[3] 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.

8569. How is a loss realized on a sale between related persons treated for tax purposes?

If an individual sells property at a loss to a related person (as defined below), that loss is disallowed and may *not* be used to offset capital gains for income tax purposes.[4] It makes no difference that the sale was a bona fide, arm's-length transaction.[5] Neither does it matter that the sale was made indirectly through an unrelated middleman.[6] The loss on the sale of stock will be disallowed even though the sale and purchase are made separately on a stock exchange and the stock certificates received are not the certificates sold.[7] However, these rules will not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.[8]

A loss realized on the exchange of properties between related persons will also be disallowed under these rules.[9]

1. IRC Sec. 1233(b)(2); Treas. Reg. §1.1233-1(c)(2).
2. IRC Sec. 1233(f); Treas. Reg. §1.1233-1(f).
3. IRC Sec. 1233(d); Treas. Reg. §1.1233-1(c)(4).
4. IRC Sec. 267(a); Treas. Reg. §1.267(a)-1 and Rev. Rul. 2008-5, 2008-3 IRB 271.
5. Treas. Reg. §1.267(a)-1(c).
6. See *Hassen v. Comm.*, 599 F.2d 305 (9th Cir. 1979).
7. *McWilliams v. Comm.*, 331 U.S. 694 (1947).
8. IRC Sec. 267(a)(1).
9. IRC Sec. 267(a)(1).

"Related persons" for this purpose includes the following:

(1) members of the same family (i.e., brothers, sisters, spouses, ancestors, and lineal descendants (but not if they are in-laws));[1]

(2) an individual and a corporation of which the individual actually or constructively owns more than 50 percent of the stock;

Example: Amy owns a parcel of land with a fair market value of $50,000. Amy's basis in the land is $100,000. Amy sells the land to a corporation wholly owned by his brother. Although Asher owns no stock of the corporation, through the attribution rules, a taxpayer is deemed to constructively own all the stock owned by his brother.[2] For that reason, the $50,000 loss would be disallowed.

(3) a grantor and a fiduciary of a trust;

The relationship between a grantor and fiduciary did not prevent recognition of loss on a sale of stock between them where the fiduciary purchased the stock in his individual capacity and where the sale was unrelated to the grantor-fiduciary relationship.[3]

(4) fiduciaries of two trusts if the same person is the grantor of both;

(5) a fiduciary and a beneficiary of the same trust;

(6) a fiduciary of a trust and a beneficiary of another trust set up by the same grantor;

(7) a fiduciary of a trust and a corporation of which the trust or the grantor of the trust actually or constructively owns more than 50 percent of the stock;

(8) a person and an IRC Section 501 tax-exempt organization controlled by the person or members of his family (as described in (1) above);

(9) a corporation and a partnership if the same person actually or constructively owns more than 50 percent of the stock of the corporation, and has more than a 50 percent interest in the partnership;

(10) two S corporations if the same persons actually or constructively own more than 50 percent of the stock of each;

(11) an S corporation and a C corporation, if the same persons actually or constructively own more than 50 percent of the stock of each;

(12) generally, an executor and a beneficiary of an estate; or

(13) possibly an individual and an individual retirement account (IRA).[4]

Special rules apply for purposes of determining constructive ownership of stock.[5]

1. See Let. Rul. 9017008.
2. IRC Sec. 267(c)(4).
3. Let. Rul. 9017008.
4. IRC Sec. 267(b).
5. See IRC Sec. 267(c).

Generally, loss will be disallowed on a sale between a partnership and a partner who owns more than a 50 percent interest, or between two partnerships if the same persons own more than a 50 percent interest in each.[1] Furthermore, with respect to transactions between two partnerships having one or more common partners *or* in which one or more of the partners in each partnership are related, a portion of the loss will be disallowed according to the relative interests of the partners.[2] If the transaction is between a partnership and an individual who is related to one of the partners, any deductions for losses will be denied with respect to the related partner's distributive share, but not with respect to the relative shares of each unrelated partner.[3] Loss on a sale or exchange (other than of inventory) between two corporations that are members of the same controlled group (using a 50 percent test instead of 80 percent) is generally not denied but is deferred until the property is transferred outside the controlled group.[4]

If the related person to whom property was originally sold (or exchanged), sells or exchanges the same property (or property whose tax basis is determined by reference to such property) at a gain, the gain will be recognized only to the extent it exceeds the loss originally denied by reason of the related parties rules.[5]

Planning Point: If one family member is considering selling a closely held business to another at a loss, there are probably better ways to achieve tax savings than for the seller to give up a tax loss. A related party buyer might pay a little more for a business than a non-related party. The goodwill may be justifiably higher because of the relationship, the customer base or the reputation, among other reasons. The seller can realize tax savings through the deal structure; the buyer can realize savings by depreciation and amortization.

8570. Can the redemption of a debt obligation result in capital gains treatment?

Redemption of a debt obligation can result in recognition of gain or loss in situations where the obligation was acquired at a premium or discount. The relevant issue for determining whether the retirement or satisfaction of the debt can result in a capital gain or loss is whether a sale or exchange has taken place. Historically, cases dealing with the subject found that no sale or exchange takes place when the maker of a debt satisfies the obligations under the debt instrument.[6] IRC Section 1271 was enacted to change this result in many situations involving the redemption of debt obligations.

Under Section 1271, amounts received by the holder when the debt instrument is redeemed are treated as having been received in an exchange.[7] Because of this, gain or loss realized upon redemption can qualify for capital gains treatment.

1. IRC Sec. 707(b).
2. Temp. Treas. Reg. §1.267(a)-2T(c), A-2.
3. Treas. Reg. §1.267(b)-1(b).
4. IRC Sec. 267(f).
5. IRC Sec. 267(d); Treas. Reg. §1.267(d)-1.
6. See, for example, *Wood v. Commissioner*, 25 TC 468 (1955).
7. IRC Sec. 1271(a)(1).

However, some debt instruments contain "original issue discount" which is a type of interest. This would be a debt instrument in which the maturity price exceeds the purchase price. The difference is the interest component.

> *Example*: Asher purchases an original issue discount debt for $1,000 that matures two years later for $1,250. The difference between the maturity amount and the purchase amount, $250, is essentially interest.

Original issue discount interest is reportable as ordinary income. Such ordinary income may be realized, however, in some transactions where there was an intention to call the obligation before maturity at the time the obligation was originally issued.[1] If this is the case, any gain realized in the transaction must be treated as ordinary income to the extent that the amount of gain does not exceed the sum of (a) the original issue discount, reduced by (b) the portion of original issue discount previously included in the gross income of any holder of the obligation.[2]

The requirement that ordinary income be recognized does not apply to certain tax-exempt obligations and to holders who purchased the debt instrument at a premium.[3]

8571. When is the gain or loss from sale or exchange of an option to purchase property treated as a capital gain or capital loss?

The sale or exchange of an option to purchase property may result in capital gain if the underlying property subject to the option is a capital asset. Similarly, losses arising from the taxpayer's failure to exercise the option may be treated as capital losses if the underlying property is a capital asset.[4]

> *Example*: Brenda is considering an investment in real property, but, because the purchase price is high, she purchases an option to buy the property for $5,000 within the next two years. The option is a capital asset because if Brenda had purchased the property outright it would have been a capital asset. Eleven months later, Brenda sells the option for $6,000. The $1,000 gain ($6,000 selling price minus $5,000 basis) is a short-term capital gain because Brenda held the option for less than one year.

Similarly, if the taxpayer fails to exercise the option, the option is treated as though it was sold or exchanged on the day the option expired for no consideration. Based on the taxpayer's holding period, the loss will be either long-term or short-term capital loss.[5]

In a recent Tax Court decision, the Tax Court held that a taxpayer was entitled to an ordinary loss deduction, rather than recognition of a capital loss, when the taxpayer abandoned an option to purchase certain real property. Because the taxpayer was in the business of purchasing and developing real property, the underlying real property was not a "capital asset." For that reason, the loss realized by the taxpayer when he abandoned his option was as an ordinary loss rather than a capital loss.[6]

1. IRC Sec. 1271(a)(2)(A).
2. IRC Sec. 1271(a)(2).
3. IRC Sec. 1271(a)(2)(B).
4. IRC Sec. 1234(a)(1).
5. IRC Sec. 1234(a)(2).
6. *Sutton v. Commissioner*, TC Summ. Op. 2013-6, IRC Sec. 1221(a).

IRC Section 1234 provides special rules with regard to options to buy or sell stock, securities or commodities. Specifically, IRC Section 1234(b) provides short-term capital gain or loss treatment for the grantor of an option as follows:

- The option lapses or is terminated in a closing transaction.
- The underlying property is stock, securities, commodities or commodities futures.
- The option is not issued in the ordinary course of the grantors trade or business

A "closing transaction" is defined as any transaction that terminates the taxpayer's obligations under the option other than an exercise or lapse of the option.[1]

See Q 8560 for a discussion of what constitutes a capital asset for purposes of capital gains treatment.

8572. Are there any special rules that apply in determining whether the sale of a patent gives rise to capital gains treatment?

Unlike typical asset sales, if the sale or exchange of a patent meets certain requirements, the sale will automatically qualify for long-term capital gains treatment regardless of the transferor's holding period and whether or not the patent would have been classified as a capital asset in the hands of the holder who transfers the patent.[2]

Sale of a patent will qualify for long-term capital gains treatment if the holder of the patent transfers either "all substantial rights" in the patent or an undivided interest in the patent.

The phrase "all substantial rights" is defined in the regulations to mean all rights in the patent that have value at the time the rights to the patent are transferred, whether or not the holder of the patent is the owner of those rights.[3] The holder does *not* transfer all substantial rights in the patent if the rights to the patent are:

(1) limited geographically within the country;

(2) confined to a period of time that is less than the entire remaining life of the patent;

(3) limited to a grant of rights, in fields of use within trades or industries, which are less than all the rights covered by the patent that exist and have value at the time of the transfer; or

(4) limited to a grant of rights that does not give the transferee rights to all the claims and inventions covered by the patent that exist and have value at the time of sale.[4]

Conversely, the holder does not lose long-term capital gain treatment by retaining rights that are not considered substantial. The regulations provide that, depending upon all of the facts

1. IRC Sec. 1234(b)(2).
2. IRC Sec. 1235(a).
3. Treas. Reg. §1.1235-2(b)(1).
4. Treas. Reg. §1.1235-2(b)(2).

and circumstances of the transaction as a whole, the holder may retain the right to prohibit sub-licensing or sub-assignment by the transferee and may also fail to convey the right to use or sell the property that is the *subject* of the patent.[1]

The holder transfers an "undivided interest" in a patent when the holder transfers the same fractional share of every substantial right in the patent. A sale of the right to income from a patent, for example, does not constitute the sale of an undivided interest in the patent.[2]

This treatment is not available to all patent holders, however. The term "holder" is defined in IRC Section 1235 to include only (1) the original inventor of the property subject to the patent and (2) an individual who obtained his rights in the patent in exchange for money or other property *before* the property subject to the patent was actually put to use *if* that individual is neither (i) the inventor's employer or (ii) related to the inventor.[3]

Planning Point: Due to the limited definition of "holder" under the patent laws, if an employer maintains the rights to patents on property invented by its employees, the employer will not be eligible for this special capital gains treatment upon sale of the patent.

8573. What is the netting process used to determine whether the taxpayer has a capital gain or loss?

The complex rules applicable to capital gains taxation essentially establish four different types of capital assets. These groups of capital assets are:

(1) short-term capital assets, with no special tax rate;

(2) 28 percent capital assets, generally consisting of collectibles gain or loss, and IRC Section 1202 gain;

(3) 25 percent capital assets, consisting of assets that generate unrecaptured IRC Section 1250 gain; and

(4) all other long-term capital assets, which are taxed according to the taxpayer's income tax bracket: 20 percent (39.6 percent income tax bracket), 15 percent (25, 28, 33, or 35 percent income tax brackets), and 0 percent capital assets for taxpayers in the 15 and 10 percent tax brackets.

Within each group, gains and losses must be netted. Generally, if, as a result of this process, there is a net loss from asset-group "(1)," it is applied to reduce any net gain from groups "(2)," "(3)," or "(4)," in that order. If there is a net loss from group "(2)," it is applied to reduce any net gain from groups "(3)" or "(4)," in that order. If there is a net loss from group "(4)," it is applied to reduce any net gain from groups "(2)" or "(3)," in that order.[4]

If net capital losses result from the netting process described above, up to $3,000 ($1,500 in the case of married individuals filing separately) of losses can be deducted against ordinary

1. Treas. Reg. §1.1235-2(b)(3).
2. Treas. Reg. §1.1235-2(c).
3. IRC Sec. 1235(b).
4. IRC Sec. 1(h)(1), as amended by ATRA; Notice 97-59, 1997-2 CB 309.

income.[1] Any losses that are deducted would be treated as reducing net loss from groups "(1)," "(2)," or "(4)," in that order.

If there are net gains, such gains would generally be taxed as described above and discussed in Q 8561 and Q 8562.

If the taxpayer has capital gains and capital losses from investment property as well as gains and losses from section 1231 business property (depreciable property used in a trade or business and held for more than one year), the latter gains and losses netted against each other. If the netting results in a net gain, the gain is treated as if it were a long-term capital gain and included in the netting process for capital gains in group (4). On the other hand, if the netting results in a net loss from Section 1231 assets, this net loss is fully deductible as an ordinary loss and not subject to capital gain and loss netting.

Example: Claire, an attorney, sold 500 shares of stock gain recognizing a $1,500 long-term capital gain and 200 shares of stock recognizing a $300 short-term capital gain. In the same year she sold an oriental rug used in her home for the past 5 years at a loss of $700 and a rental property, owned for 9 months, for a short-term capital loss of $5,000. From her office she sold a computer system (a section 1231 asset) at a loss of $1,200 and a set of law books (a section 1231 asset) at a gain of $200. Both of these had been used in her practice for more than one year.

Claire's various gains and losses ("G/L") must first be grouped according to the following column headings and a net total computed for each group:

	Long-Term Capital G/L	Short-Term Capital G/L	IRC 1231 Business Assets
500 shares of stock	1,500		
200 shares of stock		300	
oriental rug*	---	---	---
rental property		(5,000)	
computer			(1,200)
law books			200
Net totals	1,500	(4,700)	(1,000)

* No loss deduction is allowed for the oriental rug since it was held for personal use.[1]

Because the netting of the section 1231 assets resulted in a net $1,000, it is treated as a fully deductible ordinary loss and not subject to further netting. Netting short-term capital gain against short-term capital loss results in a net short-term capital loss of $4,700. That amount is netted against Claire's net long-term gain of $1,500 resulting in a net short-term loss of $3,200. Capital losses in excess of capital gains are deductible only to the extent of $3,000. The remaining $200 capital loss is carried forward to subsequent tax years subject to the same rules.

1. IRC Sec. 1211(b).
2. IRC Sec. 165.1.

8574. What is the tax significance of short-term capital gain?

Although as discussed in Q 8573 above, like long-term capital gain, short-term capital gain is netted against capital losses, net short-term capital gain is *not* subject to the preferential capital gains rates. Instead, such gain is taxed as ordinary income (up to 39.6 percent).

8575. Is there a limitation to the amount of capital losses a taxpayer may deduct in a tax year? How are disallowed capital losses treated?

Unlike ordinary losses that are deductible against any type of income (ordinary or capital), capital losses are deductible against capital gains (long and short-term). However, a noncorporate taxpayer who has capital losses in excess of capital gains is entitled to deduct from ordinary income the lesser of (a) $3,000 ($1,500 for married taxpayers filing separately) or (b) the excess of the taxpayer's net capital losses over gains.[1] Any nondeductible losses may be carried forward indefinitely to subsequent tax years. Losses that are carried forward retain their character as either short-term or long-term in future years.

Conversely, corporations are only permitted to recognize capital losses to the extent of capital gains with no exception.[2] However, unlike noncorporate taxpayers who must carry forward nondeductible losses to subsequent tax years, corporations may carry disallowed capital losses *back* for three tax years (beginning with the earliest of the three) with any remaining nondeductible capital losses to be carried forward for five successive tax years (beginning with the earliest of the five).[3]

8576. What are the reporting requirements for capital gains and losses?

New boxes have been added to Form 1099-DIV to allow for the reporting of qualified dividends (Box 1b) and post-May 5, 2003 capital gain distributions (Box 2b). Likewise, new boxes have also been added to Form 1099-B for reporting post-May 5, 2003 profits or losses from regulated futures or currency contracts.[4] Payments made in lieu of dividends ("substitute payments") are *not* eligible for the lower rates applicable to qualified dividends.

1. IRC Sec. 1211(b).
2. IRC Sec. 1211(a).
3. IRC Sec. 1212(a).
4. See Announcement 2003-55, 2003-38 IRB 597.