

IRC Provisions on Capital Assets

Note: Be sure to check effective dates and changes in percentages, such as under §1202.

§57(a)(7) Exclusion for gains on sale of certain small business stock

An amount equal to 7 percent of the amount excluded from gross income for the taxable year under section 1202.

§1202 Partial exclusion for gain from certain small business stock

(a) Exclusion.

(1) In general. In the case of a taxpayer other than a corporation, gross income shall not include 50 percent of any gain from the sale or exchange of qualified small business stock held for more than 5 years.

(2) Empowerment zone businesses.

(A) In general. In the case of qualified small business stock acquired after the date of the enactment of this paragraph in a corporation which is a qualified business entity (as defined in section 1397C(b)) during substantially all of the taxpayer's holding period for such stock, paragraph (1) shall be applied by substituting "60 percent" for "50 percent".

(B) Certain rules to apply. Rules similar to the rules of paragraphs (5) and (7) of section 1400B(b) shall apply for purposes of this paragraph .

(C) Gain after 2014 not qualified. Subparagraph (A) shall not apply to gain attributable to periods after December 31, 2014.

(D) Treatment of DC Zone. The District of Columbia Enterprise Zone shall not be treated as an empowerment zone for purposes of this paragraph.

(3) Special rules for 2009 and certain periods in 2010. In the case of qualified small business stock acquired after the date of the enactment of this paragraph and on or before the date of the enactment of the Creating Small Business Jobs Act of 2010.

(A) paragraph (1) shall be applied by substituting "75 percent" for "50 percent", and

(B) paragraph (2) shall not apply.

(4) 100 Percent exclusion for stock acquired during certain periods in 2010 and 2011. In the case of qualified small business stock acquired after the date of the enactment of the Creating Small Business Jobs Act of 2010 and before January 1, 2012—

(A) paragraph (1) shall be applied by substituting "100 percent" for "50 percent",

(B) paragraph (2) shall not apply, and

(C) paragraph (7) of section 57(a) shall not apply.

(b) Per-issuer limitation on taxpayer's eligible gain.

(1) In general. If the taxpayer has eligible gain for the taxable year from 1 or more dispositions of stock issued by any corporation, the aggregate amount of such gain from dispositions of stock issued by such corporation which may be taken into account under subsection (a) for the taxable year shall not exceed the greater of—

(A) \$10,000,000 reduced by the aggregate amount of eligible gain taken into account under subsection (a) for prior taxable years and attributable to dispositions of stock issued by such corporation, or

(B) 10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year.

For purposes of subparagraph (B) , the adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued.

(2) Eligible gain. For purposes of this subsection , the term “eligible gain” means any gain from the sale or exchange of qualified small business stock held for more than 5 years.

(3) Treatment of married individuals.

(A) Separate returns. In the case of a separate return by a married individual, paragraph (1)(A) shall be applied by substituting “\$5,000,000” for “\$10,000,000”.

(B) Allocation of exclusion. In the case of any joint return, the amount of gain taken into account under subsection (a) shall be allocated equally between the spouses for purposes of applying this subsection to subsequent taxable years.

(C) Marital status. For purposes of this subsection , marital status shall be determined under section 7703 .

(c) Qualified small business stock. For purposes of this section —

(1) In general. Except as otherwise provided in this section , the term “qualified small business stock” means any stock in a C corporation which is originally issued after the date of the enactment of the Revenue Reconciliation Act of 1993, if—

(A) as of the date of issuance, such corporation is a qualified small business, and

(B) except as provided in subsections (f) and (h) , such stock is acquired by the taxpayer at its original issue (directly or through an underwriter)—

(i) in exchange for money or other property (not including stock), or

(ii) as compensation for services provided to such corporation (other than services performed as an underwriter of such stock).

(2) Active business requirement; etc.

(A) In general. Stock in a corporation shall not be treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements of subsection (e) and such corporation is a C corporation.

(B) Special rule for certain small business investment companies.

(i) Waiver of active business requirement. Notwithstanding any provision of subsection (e) , a corporation shall be treated as meeting the active business requirements of such subsection for any period during which such corporation qualifies as a specialized small business investment company.

(ii) Specialized small business investment company. For purposes of clause (i) , the term “specialized small business investment company” means any eligible corporation (as defined in subsection (e)(4)) which is licensed to operate under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993).

(3) Certain purchases by corporation of its own stock.

(A) Redemptions from taxpayer or related person. Stock acquired by the taxpayer shall not be treated as qualified small business stock if, at any time during the 4- year period beginning on the date 2 years before the issuance of such stock, the corporation issuing such stock purchased (directly or indirectly) any of its stock from the taxpayer or from a person related (within the meaning of section 267(b) or 707(b)) to the taxpayer.

(B) Significant redemptions. Stock issued by a corporation shall not be treated as qualified business stock if, during the 2-year period beginning on the date 1 year before the issuance of such stock, such corporation made 1 or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of its stock as of the beginning of such 2-year period.

(C) Treatment of certain transactions. If any transaction is treated under section 304(a) as a distribution in redemption of the stock of any corporation, for purposes of subparagraphs

(A) and (B) , such corporation shall be treated as purchasing an amount of its stock equal to the amount treated as such a distribution under section 304(a) .

(d) Qualified small business. For purposes of this section —

(1) In general. The term “qualified small business” means any domestic corporation which is a C corporation if—

(A) the aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993, and before the issuance did not exceed \$50,000,000,

(B) the aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) does not exceed \$50,000,000, and

(C) such corporation agrees to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section .

(2) Aggregate gross assets.

(A) In general. For purposes of paragraph (1) , the term “aggregate gross assets” means the amount of cash and the aggregate adjusted bases of other property held by the corporation.

(B) Treatment of contributed property. For purposes of subparagraph (A) , the adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution.

(3) Aggregation rules.

(A) In general. All corporations which are members of the same parent-subsidiary controlled group shall be treated as 1 corporation for purposes of this subsection .

(B) Parent-subsidiary controlled group. For purposes of subparagraph (A) , the term “parent-subsidiary controlled group” means any controlled group of corporations as defined in section 1563(a)(1) , except that—

(i) “more than 50 percent” shall be substituted for “at least 80 percent” each place it appears in section 1563(a)(1) , and

(ii) section 1563(a)(4) shall not apply.

(e) Active business requirement.

(1) In general. For purposes of subsection (c)(2) , the requirements of this subsection are met by a corporation for any period if during such period—

(A) at least 80 percent (by value) of the assets of such corporation are used by such corporation in the active conduct of 1 or more qualified trades or businesses, and

(B) such corporation is an eligible corporation.

(2) Special rule for certain activities. For purposes of paragraph (1) , if, in connection with any future qualified trade or business, a corporation is engaged in—

(A) start-up activities described in section 195(c)(1)(A) ,

(B) activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under section 174 , or

(C) activities with respect to in-house research expenses described in section 41(b)(4) ,

assets used in such activities shall be treated as used in the active conduct of a qualified trade or

business. Any determination under this paragraph shall be made without regard to whether a corporation has any gross income from such activities at the time of the determination.

- (3) Qualified trade or business. For purposes of this subsection , the term “qualified trade or business” means any trade or business other than—
- (A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,
 - (B) any banking, insurance, financing, leasing, investing, or similar business,
 - (C) any farming business (including the business of raising or harvesting trees),
 - (D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A , and
 - (E) any business of operating a hotel, motel, restaurant, or similar business.
- (4) Eligible corporation. For purposes of this subsection , the term “eligible corporation” means any domestic corporation; except that such term shall not include—
- (A) a DISC or former DISC,
 - (B) a corporation with respect to which an election under section 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect,
 - (C) a regulated investment company, real estate investment trust, or REMIC, and
 - (D) a cooperative.
- (5) Stock in other corporations.
- (A) Look-thru in case of subsidiaries. For purposes of this subsection , stock and debt in any subsidiary corporation shall be disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary's assets, and to conduct its ratable share of the subsidiary's activities.
 - (B) Portfolio stock or securities. A corporation shall be treated as failing to meet the requirements of paragraph (1) for any period during which more than 10 percent of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations which are not subsidiaries of such corporation (other than assets described in paragraph (6)).
 - (C) Subsidiary. For purposes of this paragraph , a corporation shall be considered a subsidiary if the parent owns more than 50 percent of the combined voting power of all classes of stock entitled to vote, or more than 50 percent in value of all outstanding stock, of such corporation.
- (6) Working capital. For purposes of paragraph (1)(A) , any assets which—
- (A) are held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or
 - (B) are held for investment and are reasonably expected to be used within 2 years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business,
- shall be treated as used in the active conduct of a qualified trade or business. For periods after the corporation has been in existence for at least 2 years, in no event may more than 50 percent of the assets of the corporation qualify as used in the active conduct of a qualified trade or business by reason of this paragraph .
- (7) Maximum real estate holdings. A corporation shall not be treated as meeting the requirements of paragraph (1) for any period during which more than 10 percent of the total value of its assets

consists of real property which is not used in the active conduct of a qualified trade or business. For purposes of the preceding sentence, the ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business.

(8) Computer software royalties. For purposes of paragraph (1) , rights to computer software which produces active business computer software royalties (within the meaning of section 543(d)(1)) shall be treated as an asset used in the active conduct of a trade or business.

(f) Stock acquired on conversion of other stock. If any stock in a corporation is acquired solely through the conversion of other stock in such corporation which is qualified small business stock in the hands of the taxpayer—

(1) the stock so acquired shall be treated as qualified small business stock in the hands of the taxpayer, and

(2) the stock so acquired shall be treated as having been held during the period during which the converted stock was held.

(g) Treatment of pass-thru entities.

(1) In general. If any amount included in gross income by reason of holding an interest in a pass-thru entity meets the requirements of paragraph (2) —

(A) such amount shall be treated as gain described in subsection (a) , and

(B) for purposes of applying subsection (b) , such amount shall be treated as gain from a disposition of stock in the corporation issuing the stock disposed of by the pass-thru entity and the taxpayer's proportionate share of the adjusted basis of the pass-thru entity in such stock shall be taken into account.

(2) Requirements. An amount meets the requirements of this paragraph if—

(A) such amount is attributable to gain on the sale or exchange by the pass-thru entity of stock which is qualified small business stock in the hands of such entity (determined by treating such entity as an individual) and which was held by such entity for more than 5 years, and

(B) such amount is includible in the gross income of the taxpayer by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-thru entity acquired such stock and at all times thereafter before the disposition of such stock by such pass-thru entity.

(3) Limitation based on interest originally held by taxpayer. Paragraph (1) shall not apply to any amount to the extent such amount exceeds the amount to which paragraph (1) would have applied if such amount were determined by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired.

(4) Pass-thru entity. For purposes of this subsection , the term “pass-thru entity” means—

(A) any partnership,

(B) any S corporation,

(C) any regulated investment company, and

(D) any common trust fund.

(h) Certain tax-free and other transfers. For purposes of this section —

(1) In general. In the case of a transfer described in paragraph (2) , the transferee shall be treated as—

(A) having acquired such stock in the same manner as the transferor, and

(B) having held such stock during any continuous period immediately preceding the transfer during which it was held (or treated as held under this subsection) by the transferor.

(2) Description of transfers. A transfer is described in this subsection if such transfer is—

(A) by gift,

(B) at death, or

(C) from a partnership to a partner of stock with respect to which requirements similar to the requirements of subsection (g) are met at the time of the transfer (without regard to the 5-year holding period requirement).

(3) Certain rules made applicable. Rules similar to the rules of section 1244(d)(2) shall apply for purposes of this section .

(4) Incorporations and reorganizations involving nonqualified stock.

(A) In general. In the case of a transaction described in section 351 or a reorganization described in section 368 , if qualified small business stock is exchanged for other stock which would not qualify as qualified small business stock but for this subparagraph, such other stock shall be treated as qualified small business stock acquired on the date on which the exchanged stock was acquired.

(B) Limitation. This section shall apply to gain from the sale or exchange of stock treated as qualified small business stock by reason of subparagraph (A) only to the extent of the gain which would have been recognized at the time of the transfer described in subparagraph (A) if section 351 or 368 had not applied at such time. The preceding sentence shall not apply if the stock which is treated as qualified small business stock by reason of subparagraph (A) is issued by a corporation which (as of the time of the transfer described in subparagraph (A)) is a qualified small business.

(C) Successive application. For purposes of this paragraph , stock treated as qualified small business stock under subparagraph (A) shall be so treated for subsequent transactions or reorganizations, except that the limitation of subparagraph (B) shall be applied as of the time of the first transfer to which subparagraph (A) applied (determined after the application of the second sentence of subparagraph (B)).

(D) Control test. In the case of a transaction described in section 351 , this paragraph shall apply only if, immediately after the transaction, the corporation issuing the stock owns directly or indirectly stock representing control (within the meaning of section 368(c)) of the corporation whose stock was exchanged.

(i) Basis rules. For purposes of this section —

(1) Stock exchanged for property.

In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation—

(A) such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and

(B) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.

(2) Treatment of contributions to capital.

If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution.

(j) Treatment of certain short positions.

(1) In general. If the taxpayer has an offsetting short position with respect to any qualified small business stock, subsection (a) shall not apply to any gain from the sale or exchange of such stock unless—

(A) such stock was held by the taxpayer for more than 5 years as of the first day on which there was such a short position, and

(B) the taxpayer elects to recognize gain as if such stock were sold on such first day for its fair market value.

(2) Offsetting short position. For purposes of paragraph (1) , the taxpayer shall be treated as having an offsetting short position with respect to any qualified small business stock if—

(A) the taxpayer has made a short sale of substantially identical property,

(B) the taxpayer has acquired an option to sell substantially identical property at a fixed price, or

(C) to the extent provided in regulations, the taxpayer has entered into any other transaction which substantially reduces the risk of loss from holding such qualified small business stock.

For purposes of the preceding sentence, any reference to the taxpayer shall be treated as including a reference to any person who is related (within the meaning of section 267(b) or 707(b)) to the taxpayer.

(k) Regulations. The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section , including regulations to prevent the avoidance of the purposes of this section through split-ups, shell corporations, partnerships, or otherwise.

§1211 Limitation on capital losses

(a) Corporations. In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.

(b) Other taxpayers. In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of—

(1) \$3,000 (\$1,500 in the case of a married individual filing a separate return), or

(2) the excess of such losses over such gains.

§1212 Capital loss carrybacks and carryovers

(a) Corporations.

(1) In general. If a corporation has a net capital loss for any taxable year (hereinafter in this paragraph referred to as the “loss year”), the amount thereof shall be—

(A) a capital loss carryback to each of the 3 taxable years preceding the loss year, but only to the extent—

(i) such loss is not attributable to a foreign expropriation capital loss, and

(ii) the carryback of such loss does not increase or produce a net operating loss (as defined in section 172(c)) for the taxable year to which it is being carried back;

(B) except as provided in subparagraph (C) , a capital loss carryover to each of the 5 taxable years succeeding the loss year; and

(C) a capital loss carryover—

(i) in the case of a regulated investment company (as defined in section 851) to each of the 8 taxable years succeeding the loss year, and

(ii) to the extent such loss is attributable to a foreign expropriation capital loss, to each of the 10 taxable years succeeding the loss year.

and shall be treated as a short-term capital loss in each such taxable year. The entire amount of the net capital loss for any taxable year shall be carried to the earliest of the taxable years to which such loss may be carried, and the portion of such loss which shall be carried to each of the other

taxable years to which such loss may be carried shall be the excess, if any, of such loss over the total of the capital gain net income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the capital gain net income for any such prior taxable year shall be computed without regard to the net capital loss for the loss year or for any taxable year thereafter. In the case of any net capital loss which cannot be carried back in full to a preceding taxable year by reason of clause (ii) of subparagraph (A) , the capital gain net income for such prior taxable year shall in no case be treated as greater than the amount of such loss which can be carried back to such preceding taxable year upon the application of such clause (ii) .

(2) Definitions and special rules.

(A) Foreign expropriation capital loss defined. For purposes of this subsection , the term “foreign expropriation capital loss” means, for any taxable year, the sum of the losses taken into account in computing the net capital loss for such year which are—

(i) losses sustained directly by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing, or

(ii) losses (treated under section 165(g)(1) as losses from the sale or exchange of capital assets) from securities which become worthless by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing.

(B) Portion of loss attributable to foreign expropriation capital loss. For purposes of paragraph (1) , the portion of any net capital loss for any taxable year attributable to a foreign expropriation capital loss is the amount of the foreign expropriation capital loss for such year (but not in excess of the net capital loss for such year).

(C) Priority of application. For purposes of paragraph (1) , if a portion of a net capital loss for any taxable year is attributable to a foreign expropriation capital loss, such portion shall be considered to be a separate net capital loss for such year to be applied after the other portion of such net capital loss.

(3) Special rules on carrybacks. A net capital loss of a corporation shall not be carried back under paragraph (1)(A) to a taxable year—

(A) for which it is a regulated investment company (as defined in section 851) , or

(B) for which it is a real estate investment trust (as defined in section 856) .

(b) Other taxpayers.

(1) In general. If a taxpayer other than a corporation has a net capital loss for any taxable year—

(A) the excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss in the succeeding taxable year, and

(B) the excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss in the succeeding taxable year.

(2) Treatment of amounts allowed under section 1211(b)(1) or (2).

(A) In general. For purposes of determining the excess referred to in subparagraph (A) or (B) of paragraph (1) , there shall be treated as a short-term capital gain in the taxable year an amount equal to the lesser of—

(i) the amount allowed for the taxable year under paragraph (1) or (2) of section 1211(b) , or

(ii) the adjusted taxable income for such taxable year.

(B) Adjusted taxable income. For purposes of subparagraph (A) , the term “adjusted taxable income” means taxable income increased by the sum of—

- (i) the amount allowed for the taxable year under paragraph (1) or (2) of section 1211(b) , and
- (ii) the deduction allowed for such year under section 151 or any deduction in lieu thereof.

For purposes of the preceding sentence, any excess of the deductions allowed for the taxable year over the gross income for such year shall be taken into account as negative taxable income.

(c) Carryback of losses from section 1256 contracts to offset prior gains from such contracts.

- (1) In general. If a taxpayer (other than a corporation) has a net section 1256 contracts loss for the taxable year and elects to have this subsection apply to such taxable year, the amount of such net section 1256 contracts loss—
 - (A) shall be a carryback to each of the 3 taxable years preceding the loss year, and
 - (B) to the extent that, after the application of paragraphs (2) and (3) , such loss is allowed as a carryback to any such preceding taxable year—
 - (i) 40 percent of the amount so allowed shall be treated as a short-term capital loss from section 1256 contracts, and
 - (ii) 60 percent of the amount so allowed shall be treated as a long-term capital loss from section 1256 contracts.
- (2) Amount carried to each taxable year. The entire amount of the net section 1256 contracts loss for any taxable year shall be carried to the earliest of the taxable years to which such loss may be carried back under paragraph (1) . The portion of such loss which shall be carried to each of the 2 other taxable years to which such loss may be carried back shall be the excess (if any) of such loss over the portion of such loss which, after the application of paragraph (3) , was allowed as a carryback for any prior taxable year.
- (3) Amount which may be used in any prior taxable year. An amount shall be allowed as a carryback under paragraph (1) to any prior taxable year only to the extent—
 - (A) such amount does not exceed the net section 1256 contract gain for such year, and
 - (B) the allowance of such carryback does not increase or produce a net operating loss (as defined in section 172(c)) for such year.
- (4) Net section 1256 contracts loss. For purposes of paragraph (1) , the term “net section 1256 contracts loss” means the lesser of—
 - (A) the net capital loss for the taxable year determined by taking into account only gains and losses from section 1256 contracts, or
 - (B) the sum of the amounts which, but for paragraph (6)(A) , would be treated as capital losses in the succeeding taxable year under subparagraphs (A) and (B) of subsection (b)(1) .
- (5) Net section 1256 contract gain. For purposes of paragraph (1) —
 - (A) In general. The term “net section 1256 contract gain” means the lesser of—
 - (i) the capital gain net income for the taxable year determined by taking into account only gains and losses from section 1256 contracts, or
 - (ii) the capital gain net income for the taxable year.
 - (B) Special rule. The net section 1256 contract gain for any taxable year before the loss year shall be computed without regard to the net section 1256 contracts loss for the loss year or for any taxable year thereafter.
- (6) Coordination with carryforward provisions of subsection (b)(1).

- (A) Carryforward amount reduced by amount used as carryback. For purposes of applying subsection (b)(1) , if any portion of the net section 1256 contracts loss for any taxable year is allowed as a carryback under paragraph (1) to any preceding taxable year—
 - (i) 40 percent of the amount allowed as a carryback shall be treated as a short-term capital gain for the loss year, and
 - (ii) 60 percent of the amount allowed as a carryback shall be treated as a long-term capital gain for the loss year.
 - (B) Carryover loss retains character as attributable to section 1256 contract. Any amount carried forward as a short-term or long-term capital loss to any taxable year under subsection (b)(1) (after the application of subparagraph (A)) shall, to the extent attributable to losses from section 1256 contracts, be treated as loss from section 1256 contracts for such taxable year.
- (7) Other definitions and special rules. For purposes of this subsection—
- (A) Section 1256 contract. The term “section 1256 contract” means any section 1256 contract (as defined in section 1256(b)) to which section 1256 applies.
 - (B) Exclusion for estates and trusts. This subsection shall not apply to any estate or trust.

§1221 Capital asset defined

- (a) In general. For purposes of this subtitle, the term “capital asset” means property held by the taxpayer (whether or not connected with his trade or business), but does not include—
- (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
 - (2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167 , or real property used in his trade or business;
 - (3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—
 - (A) a taxpayer whose personal efforts created such property,
 - (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or
 - (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B) ;
 - (4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);
 - (5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by—
 - (A) a taxpayer who so received such publication, or
 - (B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A) ;
 - (6) any commodities derivative financial instrument held by a commodities derivatives dealer, unless—
 - (A) it is established to the satisfaction of the Secretary that such instrument has no connection to the activities of such dealer as a dealer, and

- (B) such instrument is clearly identified in such dealer's records as being described in subparagraph (A) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe);
 - (7) any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); or
 - (8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.
- (b) Definitions and special rules.
- (1) Commodities derivative financial instruments. For purposes of subsection (a)(6) —
 - (A) Commodities derivatives dealer. The term “commodities derivatives dealer” means a person which regularly offers to enter into, assume, offset, assign, or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business.
 - (B) Commodities derivative financial instrument.
 - (i) In general. The term “commodities derivative financial instrument” means any contract or financial instrument with respect to commodities (other than a share of stock in a corporation, a beneficial interest in a partnership or trust, a note, bond, debenture, or other evidence of indebtedness, or a section 1256 contract (as defined in section 1256(b)), the value or settlement price of which is calculated by or determined by reference to a specified index.
 - (ii) Specified index. The term “specified index” means any one or more or any combination of—
 - (I) a fixed rate, price, or amount, or
 - (II) a variable rate, price, or amount,
 which is based on any current, objectively determinable financial or economic information with respect to commodities which is not within the control of any of the parties to the contract or instrument and is not unique to any of the parties' circumstances.
 - (2) Hedging transaction.
 - (A) In general. For purposes of this section , the term “hedging transaction” means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily—
 - (i) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer,
 - (ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or
 - (iii) to manage such other risks as the Secretary may prescribe in regulations.
 - (B) Treatment of nonidentification or improper identification of hedging transactions. Notwithstanding subsection (a)(7) , the Secretary shall prescribe regulations to properly characterize any income, gain, expense, or loss arising from a transaction—
 - (i) which is a hedging transaction but which was not identified as such in accordance with subsection (a)(7) , or
 - (ii) which was so identified but is not a hedging transaction.
 - (3) Sale or exchange of self-created musical works. At the election of the taxpayer, paragraphs (1) and (3) of subsection (a) shall not apply to musical compositions or copyrights in musical works sold or exchanged by a taxpayer described in subsection (a)(3) .

- (4) Regulations. The Secretary shall prescribe such regulations as are appropriate to carry out the purposes of paragraph (6) and (7) of subsection (a) in the case of transactions involving related parties.

Reg §1.1221-1 Meaning of terms

- (a) The term “capital assets” includes all classes of property not specifically excluded by section 1221. In determining whether property is a “capital asset”, the period for which held is immaterial.
- (b) Property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 167 and real property used in the trade or business of a taxpayer is excluded from the term “capital assets”. Gains and losses from the sale or exchange of such property are not treated as gains and losses from the sale or exchange of capital assets, except to the extent provided in section 1231. See §1.1231-1. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term “capital assets” even though depreciation may have been allowed with respect to such property under section 23(l) of the Internal Revenue Code of 1939 before its amendment by section 121(c) of the Revenue Act of 1942 (56 Stat. 819). However, gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the provisions of subchapter P (section 1201 and following), chapter 1 of the Code.
- (c)
- (1) A copyright, a literary, musical, or artistic composition, and similar property are excluded from the term “capital assets” if held by a taxpayer whose personal efforts created such property, or if held by a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of a taxpayer whose personal efforts created such property. For purposes of this subparagraph, the phrase “similar property” includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.
- (2) In the case of sales and other dispositions occurring after July 25, 1969, a letter, a memorandum, or similar property is excluded from the term “capital asset” if held by (i) a taxpayer whose personal efforts created such property, (ii) a taxpayer for whom such property was prepared or produced, or (iii) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of a taxpayer described in subdivision (i) or (ii) of this subparagraph. In the case of a collection of letters, memorandums, or similar property held by a person who is a taxpayer described in subdivision (i), (ii), or (iii) of this subparagraph as to some of such letters, memorandums, or similar property but not as to others, this subparagraph shall apply only to those letters, memorandums, or similar property as to which such person is a taxpayer described in such subdivision. For purposes of this subparagraph, the phrase “similar property” includes, for example, such property as a draft of a speech, a manuscript, a research paper, an oral recording of any type, a transcript of an oral recording, a transcript of an oral interview or of dictation, a personal or business diary, a log or journal, a corporate archive, including a corporate charter, office correspondence, a financial record, a drawing, a photograph, or a dispatch. A letter, memorandum, or property similar to a letter or memorandum, addressed to a taxpayer shall be considered as prepared or produced for him. This subparagraph does not apply to property, such as a corporate archive, office correspondence, or a financial record, sold or disposed of as part of a going business if such property has no significant value separate and apart from its relation to and use in such business; it also does not apply to any property to which subparagraph (1) of this paragraph applies (i.e., property to which section 1221(3) applied before its amendment by section 514(a) of the Tax Reform Act of 1969 (83 Stat. 643)).
- (3) For purposes of this paragraph, in general, property is created in whole or in part by the personal efforts of a taxpayer if such taxpayer performs literary, theatrical, musical, artistic, or other

creative or productive work which affirmatively contributes to the creation of the property, or if such taxpayer directs and guides others in the performance of such work. A taxpayer, such as corporate executive, who merely has administrative control of writers, actors, artists, or personnel and who does not substantially engage in the direction and guidance of such persons in the performance of their work, does not create property by his personal efforts. However, for purposes of subparagraph (2) of this paragraph, a letter or memorandum, or property similar to a letter or memorandum, which is prepared by personnel who are under the administrative control of a taxpayer, such as a corporate executive, shall be deemed to have been prepared or produced for him whether or not such letter, memorandum, or similar property is reviewed by him.

(4) For the application to section 1231 to the sale or exchange of property to which this paragraph applies, see §1.1231-1. For the application of section 170 to the charitable contribution of property to which this paragraph applies, see section 170(e) and the regulations thereunder.

(d) Section 1221(4) excludes from the definition of “capital asset” accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business. Thus, if a taxpayer acquires a note receivable for services rendered, reports the fair market value of the note as income, and later sells the note for less than the amount previously reported, the loss is an ordinary loss. On the other hand, if the taxpayer later sells the note for more than the amount originally reported, the excess is treated as ordinary income.

(e) Obligations of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, are excluded from the term “capital assets.” An obligation may be issued on a discount basis even though the price paid exceeds the face amount. Thus, although the Second Liberty Bond Act (31 U.S.C. 754) provides that United States Treasury bills shall be issued on a discount basis, the issuing price paid for a particular bill may, by reason of competitive bidding, actually exceed the face amount of the bill. Since the obligations of the type described in this paragraph are excluded from the term “capital assets”, gains or losses from the sale or exchange of such obligations are not subject to the limitations provided in such subchapter P. It is, therefore, not necessary for a taxpayer (other than a life insurance company taxable under part I (section 801 and following), subchapter L, chapter 1 of the Code, as amended by the Life Insurance Company Tax Act of 1955, (70 Stat. 36), and, in the case of taxable years beginning before January 1, 1955, subject to taxation only on interest, dividends, and rents) to segregate the original discount accrued and the gain or loss realized upon the sale or other disposition of any such obligation. See section 454(b) with respect to the original discount accrued. The provisions of this paragraph may be illustrated by the following examples:

Example (1). A (not a life insurance company) buys a \$100,000, 90-day Treasury bill upon issuance for \$99,998. As of the close of the forty-fifth day of the life of such bill, he sells it to B (not a life insurance company) for \$99,999.50. The entire net gain to A of \$1.50 may be taken into account as a single item of income, without allocating \$1 to interest and \$0.50 to gain. If B holds the bill until maturity his net gain of \$0.50 may similarly be taken into account as a single item of income, without allocating \$1 to interest and \$0.50 to loss.

Example (2). The facts in this example are the same as in example (1) except that the selling price to B is \$99,998.50. The net gain to A of \$0.50 may be taken into account without allocating \$1 to interest and \$0.50 to loss, and, similarly, if B holds the bill until maturity his entire net gain of \$1.50 may be taken into account as a single item of income without allocating \$1 to interest and \$0.50 to gain.