

interest in *PRS* transferred to *T*. Accordingly, *A* will recognize \$1,000 ordinary income and \$2,500 (\$3,500-\$1,000) of capital gain on account of the transfer to *T* of one-half of *A*'s interest in *PRS*. Fifty percent (\$1,250) of that gain is long-term capital gain and 50 percent (\$1,250) is short-term capital gain.

*Example 6. Sale of units of interests in a partnership.* A publicly traded partnership (*PRS*) has ownership interests that are segregated into identifiable units of interest. *A* owns 10 limited partnership units in *PRS* for which *A* paid \$10,000 on January 1, 1999. On August 1, 2000, *A* purchases five additional units for \$10,000. At the time of purchase, the fair market value of each unit has increased to \$2,000. *A*'s holding period for one-third (\$10,000/\$30,000) of the interest in *PRS* begins on the day after the purchase of the five additional units. Less than one year later, *A* sells five units of ownership in *PRS* for \$11,000. At the time, *A*'s basis in the 15 units of *PRS* is \$20,000, and *A*'s capital gain on the sale of 5 units is \$4,333 (amount realized of \$11,000—one-third of the adjusted basis or \$6,667). For purposes of determining the holding period, *A* can designate the specific units of *PRS* sold. If *A* properly identifies the five units sold as five of the ten units for which *A* has a long-term holding period and elects to use the identification method for all subsequent sales or exchanges of interests in the partnership by using the actual holding period in reporting the transaction on *A*'s Federal income tax return, the capital gain realized will be long-term capital gain.

*Example 7. Disproportionate distribution.* In 1997, *A* and *B* each contribute cash of \$50,000 to form and become equal partners in a partnership (*PRS*). More than one year later, *A* receives a distribution worth \$22,000 from *PRS*, which reduces *A*'s interest in *PRS* to 36 percent. After the distribution, *B* owns 64 percent of *PRS*. The holding periods of *A* and *B* in their interests in *PRS* are not affected by the distribution.

*Example 8. Gain or loss as a result of a distribution.* (i) On January 1, 1996, *A* contributes property with a basis of \$10 and a fair market value of \$10,000 in exchange for an interest in a partnership (*ABC*). On September 30, 2000, when *A*'s interest in *ABC* is worth \$12,000 (and the basis of *A*'s partnership interest is still \$10), *A* contributes \$12,000 cash in exchange for an additional interest in *ABC*. *A* is allocated a loss equal to \$10,000 by *ABC* for the taxable year ending December 31, 2000, thereby reducing the basis of *A*'s partnership interest to \$2,010. On February 1, 2001, *ABC* makes a cash distribution to *A* of \$10,000. *ABC* holds no inventory or unrealized receivables. (assume that *A* is allocated no gain or loss for the taxable year ending December 31, 2001, so that the basis of *A*'s partnership interest does not increase or decrease as a result of such allocations.)

(ii) The netting rule contained in paragraph (b)(2) of this section provides that, in determining the holding period of *A*'s interest in *ABC*, the cash contribution made on September 30, 2000, must be reduced by the distribution made on February 1, 2001. Accordingly, for purposes of determining the holding period of *A*'s interest in *ABC*, *A* is treated as having made a cash contribution of \$2,000 (\$12,000-\$10,000) to *ABC* on September 30, 2000. *A*'s holding period in one-seventh of *A*'s interest in *ABC* (\$2,000 cash contributed over the \$14,000 value of the entire interest (determined as if only \$2,000 were contributed rather than \$12,000)) begins on the day after the cash contribution. *A* recognizes \$7,990 of capital gain as a result of the distribution. See section 731(a)(1). One-seventh of the capital gain recognized as a result of the distribution is short-term capital gain, and six-sevenths of the capital gain is long-term capital gain. After the distribution, *A*'s basis in the interest in *PRS* is \$0, and the holding period for the interest in *PRS* continues to be divided in the same proportions as before the distribution.

(g) *Effective date.* This section applies to transfers of partnership interests and distributions of property from a partnership that occur on or after September 21, 2000.

[T.D. 8902, 65 FR 57099, Sept. 21, 2000]

#### SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

### § 1.1231-1 Gains and losses from the sale or exchange of certain property used in the trade or business.

(a) *In general.* Section 1231 provides that, subject to the provisions of paragraph (e) of this section, a taxpayer's gains and losses from the disposition (including involuntary conversion) of assets described in that section as *property used in the trade or business* and from the involuntary conversion of capital assets held for more than 6 months shall be treated as long-term capital gains and losses if the total gains exceed the total losses. If the total gains do not exceed the total losses, all such gains and losses are treated as ordinary gains and losses. Therefore, if the taxpayer has no gains subject to section 1231, a recognized loss from the condemnation (or from a sale or exchange under threat of condemnation) of even a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in

1977) is an ordinary loss. Capital assets subject to section 1231 treatment include only capital assets involuntarily converted. The noncapital assets subject to section 1231 treatment are (1) depreciable business property and business real property held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) other than stock in trade and certain copyrights and artistic property and, in the case of sales and other dispositions occurring after July 25, 1969, other than a letter, memorandum, or property similar to a letter or memorandum; (2) timber, coal, and iron ore which do not otherwise meet the requirements of section 1231 but with respect to which section 631 applies; and (3) certain livestock and unharvested crops. See paragraph (c) of this section.

(b) *Treatment of gains and losses.* For the purpose of applying section 1231, a taxpayer must aggregate his recognized gains and losses from:

(1) The sale, exchange, or involuntary conversion of property used in the trade or business (as defined in section 1231(b)), and

(2) The involuntary conversion (but not sale or exchange) of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

If the gains to which section 1231 applies exceed the losses to which the section applies, the gains and losses are treated as long-term capital gains and losses and are subject to the provisions of parts I and II (section 1201 and following), subchapter P, chapter 1 of the Code, relating to capital gains and losses. If the gains to which section 1231 applies do not exceed the losses to which the section applies, the gains and losses are treated as ordinary gains and losses. Therefore, in the latter case, a loss from the involuntary conversion of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) is treated as an ordinary loss and is not subject to the limitation on capital losses in section 1211. The phrase *involuntary conversion* is defined in paragraph (e) of this section.

(c) *Transactions to which section applies.* Section 1231 applies to recognized gains and losses from the following:

(1) The sale, exchange, or involuntary conversion of property held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and used in the taxpayer's trade or business, which is either real property or is of a character subject to the allowance for depreciation under section 167 (even though fully depreciated), and which is not:

(i) Property of a kind which would properly be includible 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 business;

(ii) A copyright, a literary, musical, or artistic composition, or similar property, or (in the case of sales and other dispositions occurring after July 25, 1969) a letter, memorandum, or property similar to a letter or memorandum, held by a taxpayer described in section 1221(3); or

(iii) Livestock held for draft, breeding, dairy, or sporting purposes, except to the extent included under paragraph (4) of this paragraph, or poultry.

(2) The involuntary conversion of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(3) The cutting or disposal of timber, or the disposal of coal or iron ore, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(4) The sale, exchange, or involuntary conversion of livestock if the requirements of § 1.1231-2 are met.

(5) The sale, exchange, or involuntary conversion of unharvested crops on land which is (i) used in the taxpayer's trade or business and held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and (ii) sold or exchanged at the same time and to the same person. See paragraph (f) of this section.

For purposes of section 1231, the phrase *property used in the trade or business*

means property described in this paragraph (other than property described in subparagraph (2) of this paragraph). Notwithstanding any of the provisions of this paragraph, section 1231(a) does not apply to gains and losses under the circumstances described in paragraph (e) (2) or (3) of this section.

(d) *Extent to which gains and losses are taken into account.* All gains and losses to which section 1231 applies must be taken into account in determining whether and to what extent the gains exceed the losses. For the purpose of this computation, the provisions of section 1211 limiting the deduction of capital losses do not apply, and no losses are excluded by that section. With that exception, gains are included in the computations under section 1231 only to the extent that they are taken into account in computing gross income, and losses are included only to the extent that they are taken into account in computing taxable income. The following are examples of gains and losses not included in the computations under section 1231:

(1) Losses of a personal nature which are not deductible by reason of section 165 (c) or (d), such as losses from the sale of property held for personal use;

(2) Losses which are not deductible under section 267 (relating to losses with respect to transactions between related taxpayers) or section 1091 (relating to losses from wash sales);

(3) Gain on the sale of property (to which section 1231 applies) reported for any taxable year on the installment method under section 453, except to the extent the gain is to be reported under section 453 for the taxable year; and

(4) Gains and losses which are not recognized under section 1002, such as those to which sections 1031 through 1036, relating to common nontaxable exchanges, apply.

(e) *Involuntary conversion*—(1) *General rule.* For purposes of section 1231, the terms *compulsory or involuntary conversion* and *involuntary conversion* of property mean the conversion of property into money or other property as a result of complete or partial destruction, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof. Losses upon the complete or partial de-

struction, theft, seizure, requisition, or condemnation of property are treated as losses upon an involuntary conversion whether or not there is a conversion of the property into other property or money and whether or not the property is uninsured, partially insured, or totally insured. For example, if a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), with an adjusted basis of \$400, but not held for the production of income, is stolen, and the loss which is sustained in the taxable year 1956 is not compensated for by insurance or otherwise, section 1231 applies to the \$400 loss. For certain exceptions to this subparagraph, see subparagraphs (2) and (3) of this paragraph.

(2) *Certain uninsured losses.* Notwithstanding the provisions of subparagraph (1) of this paragraph, losses sustained during a taxable year beginning after December 31, 1957, and before January 1, 1970, with respect to both property used in the trade or business and any capital asset held for more than 6 months and held for the production of income, which losses arise from fire, storm, shipwreck, or other casualty, or from theft, and which are not compensated for by insurance in any amount, are not losses to which section 1231(a) applies. Such losses shall not be taken into account in applying the provisions of this section.

(3) *Exclusion of gains and losses from certain involuntary conversions.* Notwithstanding the provisions of subparagraph (1) of this paragraph, if for any taxable year beginning after December 31, 1969, the recognized losses from the involuntary conversion as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) exceed the recognized gains from the involuntary conversion of any such property as a result of fire, storm, shipwreck, or other casualty, or from theft, such gains and losses are not gains and losses to which section 1231 applies and shall not be

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taken into account in applying the provisions of this section. The net loss, in effect, will be treated as an ordinary loss. This subparagraph shall apply whether such property is uninsured, partially insured, or totally insured and, in the case of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), whether the property is property used in the trade or business, property held for the production of income, or a personal asset.

(f) *Unharvested crops.* Section 1231 does not apply to a sale, exchange, or involuntary conversion of an unharvested crop if the taxpayer retains any right or option to reacquire the land the crop is on, directly or indirectly (other than a right customarily incident to a mortgage or other security transaction). The length of time for which the crop, as distinguished from the land, is held is immaterial. A leasehold or estate for years is not *land* for the purpose of section 1231.

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

*Example 1.* A, an individual, makes his income tax return on the calendar year basis. A's recognized gains and losses for 1957 of the kind described in section 1231 are as follows:

	Gains	Losses
1. Gain on sale of machinery, used in the business and subject to an allowance for depreciation, held for more than 6 months .....	\$4,000	
2. Gain reported in 1957 (under section 453) on installment sale in 1956 of factory premises used in the business (including building and land, each held for more than 6 months) .....	6,000	
3. Gain reported in 1957 (under section 453) on installment sale in 1957 of land held for more than 6 months, used in the business as a storage lot for trucks .....	2,000	
4. Gain on proceeds from requisition by Government of boat, held for more than 6 months, used in the business and subject to an allowance for depreciation .....	500	
5. Loss upon the destruction by fire of warehouse, held for more than 6 months and used in the business (excess of adjusted basis of warehouse over compensation by insurance, etc.) ..		\$3,000
6. Loss upon theft of unregistered bearer bonds, held for more than 6 months .....		5,000
7. Loss in storm of pleasure yacht, purchased in 1950 for \$1,800 and having a fair market value of \$1,000 at the time of the storm .....		1,000

	Gains	Losses
8. Total gains .....	12,500	
9. Total losses .....		9,000
10. Excess of gains over losses .....	3,500	

Since the aggregate of the recognized gains (\$12,500) exceeds the aggregate of the recognized losses (\$9,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months. For any taxable year beginning after December 31, 1957, and before January 1, 1970, the \$5,000 loss upon theft of bonds (item 6) would not be taken into account under section 1231. See paragraph (e)(2) of this section.

*Example 2.* If in example (1), A also had a loss of \$4,000 from the sale under threat of condemnation of a capital asset acquired for profit and held for more than six months, then the gains (\$12,500) would not exceed the losses (\$9,000 plus \$4,000, or \$13,000). Neither the loss on that sale nor any of the other items set forth in example (1) would then be treated as gains and losses from the sale or exchanges of capital assets, but all of such items would be treated as ordinary gains and losses. Likewise, if A had no other gain or loss, the \$4,000 loss would be treated as an ordinary loss.

*Example 3.* A's yacht, used for pleasure and acquired for that use in 1945 at a cost of \$25,000, was requisitioned by the Government in 1957 for \$15,000. A sustained no loss deductible under section 165(c) and since no loss with respect to the requisition is recognizable, the loss will not be included in the computations under section 1231.

*Example 4.* A, an individual, makes his income tax return on a calendar year basis. During 1970 trees on A's residential property which were planted in 1950 after the purchase of such property were destroyed by fire. The loss, which was in the amount of \$2,000 after applying section 165(c)(3), was not compensated for by insurance or otherwise. During the same year A also recognized a \$1,500 gain from insurance proceeds compensating him for the theft sustained in 1970 of a diamond brooch purchased in 1960 for personal use. A has no other gains or losses for 1970 from the involuntary conversion of property. Since the recognized losses exceed the recognized gains from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months, neither the gain nor the loss is included in making the computations under section 1231.

*Example 5.* The facts are the same as in example (4), except that A also recognized a gain of \$1,000 from insurance proceeds compensating him for the total destruction by fire of a truck, held for more than 6 months,

used in A's business and subject to an allowance for depreciation. A has no other gains or losses for 1970 from the involuntary conversion of property. Since the recognized losses (\$2,000) do not exceed the recognized gains (\$2,500) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months, such gains and losses are included in making the computations under section 1231. Thus, if A has no other gains or losses for 1970 to which section 1231 applies, the gains and losses from these involuntary conversions are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months.

*Example 6.* The facts are the same as in example (5) except that A also has the following recognized gains and losses for 1970 to which section 1231 applies:

	Gains	Losses
Gain on sale of machinery, used in the business and subject to an allowance for depreciation, held for more than 6 months .....	\$4,000	
Gain reported in 1970 (under section 453) on installment sale in 1969 of factory premises used in the business (including building and land, each held for more than 6 months) .....	6,000	
Gain reported in 1970 (under section 453) on installment sale in 1970 of land held for more than 6 months, used in the business as a storage lot for trucks .....	\$2,000	
Loss upon the sale in 1970 of warehouse, used in the business and subject to an allowance for depreciation, held for more than 6 months .....		\$5,000
Total gains .....	12,000	
Total losses .....		5,000

Since the aggregate of the recognized gains (\$14,500) exceeds the aggregate of the recognized losses (\$7,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months.

*Example 7.* B, an individual, makes his income tax return on the calendar year basis. During 1970 furniture used in his business and held for more than 6 months was destroyed by fire. The recognized loss, after compensation by insurance, was \$2,000. During the same year B recognized a \$1,000 gain upon the sale of a parcel of real estate used in his business and held for more than 6 months, and a \$6,000 loss upon the sale of stock held for more than 6 months. B has no other gains or losses for 1970 from the involuntary conversion, or the sale or exchange of, property. The \$6,000 loss upon the sale of stock is not a loss to which section 1231 applies since the stock is not property used in

the trade or business, as defined in section 1231(b). The \$2,000 loss upon the destruction of the furniture is not a loss to which section 1231 applies since the recognized losses (\$2,000) exceed the recognized gains (\$0) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months. Accordingly, the \$1,000 gain upon the sale of real estate is considered to be gain from the sale or exchange of a capital asset held for more than 6 months since the gains (\$1,000) to which section 1231 applies exceed the losses (\$0) to which such section applies.

*Example 8.* The facts are the same as in example (7) except that B also recognized a gain of \$4,000 from insurance proceeds compensating him for the total destruction by fire of a freighter, held for more than 6 months, used in B's business and subject to an allowance for depreciation. Since the recognized losses (\$2,000) do not exceed the recognized gains (\$4,000) from the involuntary conversion for 1970 as a result of fire, storm, shipwreck, or other casualty, or from theft, of any property used in the trade or business or of any capital asset held for more than 6 months, such gains and losses are included in making the computations under section 1231. Since the aggregate of the recognized gains to which section 1231 applies (\$5,000) exceeds the aggregate of the recognized losses to which such section applies (\$2,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than 6 months. The \$6,000 loss upon the sale of stock is not taken into account in making such computation since it is not a loss to which section 1231 applies.

[T.D. 6500, 25 FR 12006, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9309, July 27, 1965; T.D. 7369, 40 FR 29841, July 16, 1975; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7829, 47 FR 38515, Sept. 1, 1982]

**§ 1.1231-2 Livestock held for draft, breeding, dairy, or sporting purposes.**

(a)(1) In the case of cattle, horses, or other livestock acquired by the taxpayer after December 31, 1969, section 1231 applies to the sale, exchange, or involuntary conversion of such cattle, horses, or other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him:

(i) For 24 months or more from the date of acquisition in the case of cattle or horses, or