

application of section 1232(a)(2). Pursuant to section 7851(a)(1)(C), the regulations prescribed in this section shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, although such years are subject to the Internal Revenue Code of 1939.

[T.D. 7154, 36 FR 25009, Dec. 28, 1971]

**§ 1.1233-1 Gains and losses from short sales.**

(a) *General.* (1) For income tax purposes, a short sale is not deemed to be consummated until delivery of property to close the short sale. Whether the recognized gain or loss from a short sale is capital gain or loss or ordinary gain or loss depends upon whether the property so delivered constitutes a capital asset in the hands of the taxpayer.

(2) Thus, if a dealer in securities makes a short sale of X Corporation stock, ordinary gain or loss results on closing of the short sale if the stock used to close the short sale was stock which he held primarily for sale to customers in the ordinary course of his trade or business. If the stock used to close the short sale was a capital asset in his hands, or if the taxpayer in this example was not a dealer, a capital gain or loss would result.

(3) Generally, the period for which a taxpayer holds property delivered to close a short sale determines whether long-term or short-term capital gain or loss results.

(4) Thus, if a taxpayer makes a short sale of shares of stock and covers the short sale by purchasing and delivering shares which he held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), the recognized gain or loss would be considered short-term capital gain or loss. If the short sale is made through a broker and the broker borrows property to make a delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

(5) For rules for determining the date of sale for purposes of applying under section 1091 the 61-day period applica-

ble to a short sale of stock or securities at a loss, see paragraph (g) of § 1.1091-1.

(b) *Hedging transactions.* Under section 1233(g), the provisions of section 1233 and this section shall not apply to any bona fide hedging transaction in commodity futures entered into by flour millers, producers of cloth, operators of grain elevators, etc., for the purpose of their business. Gain or loss from a short sale of commodity futures which does not qualify as a hedging transaction shall be considered gain or loss from the sale or exchange of a capital asset if the commodity future used to close the short sale constitutes a capital asset in the hands of the taxpayer as explained in paragraph (a) of this section.

(c) *Special short sales—(1) General.* Section 1233 provides rules as to the tax consequences of a short sale of property if gain or loss from the short sale is considered as gain or loss from the sale or exchange of a capital asset under section 1233(a) and paragraph (a) of this section and if, at the time of the short sale or on or before the date of the closing of the short sale, the taxpayer holds property substantially identical to that sold short. The term *property* is defined for purposes of such rules to include only stocks and securities (including stocks and securities dealt with on a *when issued* basis) and commodity futures, which are capital assets in the hands of the taxpayer. Certain restrictions on the application of the section to commodity futures are provided in section 1233(e) and paragraph (d)(2) of this section. Section 1233(f) contains special provisions governing the operation of rule (2) in subparagraph (2) of this paragraph in the case of a purchase and short sale of stock (as defined in subparagraph (3) qualifying as an arbitrage operation. See paragraph (f) of this section for detailed rules relating to arbitrage operations in stocks and securities.

(2) *Treatment of special short sales.* The first two rules, which are set forth in section 1233(b), are applicable whenever property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in

1977) (determined without regard to rule (2), contained in this subparagraph, relating to the holding period) or is acquired by him after the short sale and on or before the date of the closing thereof. These rules are:

*Rule (1).* Any gain upon the closing of such short sale shall be considered as a gain upon the sale or exchange of a capital asset held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) (notwithstanding the period of time any property used to close such short sale has been held); and

*Rule (2).* The holding period of such substantially identical property shall be considered to begin (notwithstanding the provisions of section 1223) on the date of the closing of such short sale or on the date of a sale, gift, or other disposition of such property, whichever date occurs first.

(3) *Options to sell.* For the purpose of rule (1) and rule (2) in subparagraph (2) of this paragraph, the acquisition of an option to sell property at a fixed price shall be considered a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale, except that any option to sell property at a fixed price acquired on or after August 17, 1954 (the day after enactment of the Internal Revenue Code of 1954), shall not be considered a short sale and the exercise or failure to exercise such option shall not be considered as the closing of a short sale provided that the option and property identified as intended to be used in its exercise are acquired on the same date. This exception shall not apply, if the option is exercised, unless it is exercised by the sale of the property so identified. In the case of any option not exercised which falls within this exception, the cost of such option shall be added to the basis of the property with which such option is identified. If the option itself does not specifically identify the property intended to be used in exercising the option, then the identification of such property shall be made by appropriate entries in the taxpayer's records within 15 days after the date such property is acquired or before November 17, 1956, whichever expiration date later occurs.

(4) *Treatment of losses.* The third rule, which is set forth in section 1233(d), is applicable whenever property substan-

tially identical to that sold short has been held by the taxpayer on the date of the short sale for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). This rule is:

*Rule (3).* Any loss upon the closing of such short sale shall be considered as a loss upon the sale or exchange 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), not withstanding the period of time any property used to close such short sale has been held. For the purpose of this rule, the acquisition of an option to sell property at a fixed price is not considered a short sale, and the exercise or failure to exercise such option is not considered as a closing of a short sale.

(5) *Application of rules.* Rules (1) and (3) contained in subparagraphs (2) and (4) of this paragraph do not apply to the gain or loss attributable to so much of the property sold short as exceeds in quantity the substantially identical property referred to in section 1233 (b) and (d), respectively. Except as otherwise provided in section 1233(f), rule (2) in subparagraph (2) of this paragraph applies to the substantially identical property referred to in section 1233(b) in the order of the dates of the acquisition of such property, but only to so much of such property as does not exceed the quantity sold short. If property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), or is acquired by him after the short sale and on or before the date of the closing thereof, and if property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), all three rules are applicable.

(6) *Examples.* The following examples illustrate the application of these rules to short sales of stock in the case of a taxpayer who makes his return on the basis of the calendar year:

*Example 1.* A buys 100 shares of X stock at \$10 per share on February 1, 1955, sells short 100 shares of X stock at \$16 per share on July 1, 1955, and closes the short sale on August 2,

1955, by delivering the 100 shares of X stock purchased on February 1, 1955, to the lender of the stock used to effect the short sale. Since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of \$600 realized upon the closing of the short sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain.

*Example 2.* A buys 100 shares of X stock at \$10 per share on February 1, 1955, sells short 100 shares of X stock at \$16 per share on July 1, 1955, closes the short sale on August 1, 1955, with 100 shares of X stock purchased on that date at \$18 per share, and on August 2, 1955, sells at \$18 per share the 100 shares of X stock purchased on February 1, 1955. The \$200 loss sustained upon the closing of the short sale is a short-term capital loss to which section 1233(d) has no application. By application of rule (2) in subparagraph (2) of this paragraph, however, the holding period of the 100 shares of X stock purchased on February 1, 1955, and sold on August 2, 1955 is considered to begin on August 1, 1955, the date of the closing of the short sale. The \$800 gain realized upon the sale of such stock is, therefore, a short-term capital gain.

*Example 3.* A buys 100 shares of X stock at \$10 per share on February 1, 1955, sells short 100 shares of X stock at \$16 per share on September 1, 1955, sells on October 1, 1955, at \$18 per share the 100 shares of X stock purchased on February 1, 1955, and closes the short sale on October 1, 1955, with 100 shares of X stock purchased on that date at \$18 per share. The \$800 gain realized upon the sale of the 100 shares of X stock purchased on February 1, 1955, is a long-term capital gain to which section 1233(b) has no application. Since A had held 100 shares of X stock on the date of the short sale for more than 6 months, the \$200 loss sustained upon the closing of the short sale is, by application of rule (3) in subparagraph (4) of this paragraph, a long-term capital loss. If, instead of purchasing 100 shares of X stock on October 1, 1955, A closed the short sale with the 100 shares of stock purchased on February 1, 1955, the \$600 gain realized on the closing of the short sale would be a long-term capital gain to which section 1233(b) has no application.

*Example 4.* A sells short 100 shares of X stock at \$16 per share on February 1, 1955. He buys 250 shares of X stock on March 1, 1955, at \$10 per share and holds the latter stock until September 2, 1955 (more than 6 months), at which time, 100 shares of the 250 shares of X stock are delivered to close the short sale made on February 1, 1955. Since substantially identical property was acquired by A after the short sale and before it was closed, the \$600 gain realized on the closing of the short sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain. The holding period of the remaining 150 shares of X stock is not

affected by section 1233 since this amount of the substantially identical property exceeds the quantity of the property sold short.

*Example 5.* A buys 100 shares of X stock at \$10 per share on February 1, 1955, buys an additional 100 shares of X stock at \$20 per share on July 1, 1955, sells short 100 shares of X stock at \$30 per share on September 1, 1955, and closes the short sale on February 1, 1956, by delivering the 100 shares of X stock purchased on February 1, 1955, to the lender of the stock used to effect the short sale. Since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of \$2,000 realized upon the closing of the short sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain and the holding period of the 100 shares of X stock purchased on July 1, 1955, is considered, by application of rule (2) in subparagraph (2) of this paragraph to begin on February 1, 1956, the date of the closing of the short sale. If, however, the 100 shares of X stock purchased on July 1, 1955, had been used by A to close the short sale, then, since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of \$1,000 realized upon the closing of the short sale would be, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain, but the holding period of the 100 shares of X stock purchased on February 1, 1955, would not be affected by section 1233. If, on the other hand, A purchased an additional 100 shares of X stock at \$40 per share on February 1, 1956, and used such shares to close the short sale at that time, then, since 100 shares of X stock had been held by A on the date of the short sale for more than 6 months, the loss of \$1,000 sustained upon the closing of the short sale would be, by application of rule (3) in subparagraph (4) of this paragraph, a long-term capital loss, and since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the holding period of the 100 shares of X stock purchased on July 1, 1955, would be considered, by application of rule (2) in subparagraph (2) of this paragraph, to begin on February 1, 1956, but the holding period of the 100 shares of X stock purchased on February 1, 1955, would not be affected by section 1233.

*Example 6.* A buys 100 shares of X preferred stock at \$10 per share on February 1, 1955. On July 1, 1955, he enters into a contract to sell 100 shares of XY common stock at \$16 per share when, as, and if issued pursuant to a particular plan of reorganization. On August 2, 1955, he receives 100 shares of XY common stock in exchange for the 100 shares of X preferred stock purchased on February 1, 1955, and delivers such common shares in performance of his July 1, 1955, contract. Assume that the exchange of the X preferred stock

for the XY common stock is a tax-free exchange pursuant to section 354(a)(1), and that on the basis of all of the facts and circumstances existing on July 1, 1955, the *when issued* XY common stock is substantially identical to the X preferred stock. Since 100 shares of substantially identical property had been held by A for not more than 6 months on the date of entering into the July 1, 1955, contract of sale, the gain of \$600 realized upon the closing of the contract of sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain.

(d) *Other rules for the application of section 1233—(1) Substantially identical property.* The term *substantially identical property* is to be applied according to the facts and circumstances in each case. In general, as applied to stocks or securities, the term has the same meaning as the term *substantially identical stock or securities* used in section 1091, relating to wash sales of stocks or securities. For certain restrictions on the term as applied to commodity futures see subparagraph (2) of this paragraph. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. In certain situations they may be substantially identical; for example, in the case of a reorganization the facts and circumstances may be such that the stocks and securities of predecessor and successor corporations are substantially identical property. Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, in certain situations, as, for example, where the preferred stock or bonds are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical property. Similarly, depending on the facts and circumstances, the term may apply to the stocks and securities to be received in a corporate reorganization or recapitalization, traded in on a when issued basis, as compared with the stocks or securities to be exchanged in such reorganization or recapitalization.

(2) *Commodity futures.* (i) As provided in section 1233(e)(2)(B), in the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in one calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month. For example, commodity futures in May wheat and July wheat are not considered, for the purpose of section 1233, substantially identical property. Similarly, futures in different commodities which are not generally through custom of the trade used as hedges for each other (such as corn and wheat, for example) are not considered substantially identical property. If commodity futures are otherwise substantially identical property, the mere fact that they were procured through different brokers will not remove them from the scope of the term *substantially identical property*. Commodity futures procured on different markets may come within the term *substantially identical property* depending upon the facts and circumstances in the case, with the historical similarity in the price movements in the two markets as the primary factor to be considered.

(ii) Section 1233(e)(3), relating to so-called *arbitrage* transactions in commodity futures, provides that where a taxpayer enters into two commodity futures transactions on the same day, one requiring delivery by him in one market and the other requiring delivery to him of the same (or substantially identical) commodity in the same calendar month in a different market, and the taxpayer subsequently closes both such transactions on the same day, section 1233 shall have no application to so much of the commodity involved in either such transaction as does not exceed in quantity the commodity involved in the other. Section 1233(f), relating to arbitrage operations in stocks or securities, has no application to arbitrage transactions in commodity futures.

(iii) The following example indicates the application of section 1233 to a commodity futures transaction:

*Example:* A, who makes his return on the basis of the calendar year, on February 1,

1955, enters into a contract through broker X to purchase 10,000 bushels of December wheat on the Chicago market at \$2 per bushel. On July 1, 1955, he enters into a contract through broker Y to sell 10,000 bushels of December wheat on the Chicago market at \$2.25 per bushel. On August 2, 1955, he closes both transactions at \$2.50 per bushel. The \$2,500 loss sustained on the closing of the short sale is a short-term capital loss to which section 1233(d) has no application. By application of rule (2) in paragraph (c)(2) of this section, however, the holding period of the futures contract entered into on February 1, 1955, is considered to begin on August 2, 1955, the date of the closing of the short sale. The \$5,000 gain realized upon the closing of such contract is, therefore, a short-term capital gain.

(3) *Husband and wife.* Section 1233(e)(2)(C) provides that, in the case of a short sale of property by an individual, the term *taxpayer* in the application of subsections (b), (d), and (e) shall be read as *taxpayer or his spouse*. Thus, if the spouse of a taxpayer holds or acquires property substantially identical to that sold short by the taxpayer, and other conditions of subsections (b), (d), and (e) are met, then the rules set forth therein are applicable to the same extent as if the taxpayer held or acquired the substantially identical property. For this purpose, an individual who is legally separated from the taxpayer under a decree of divorce or of separate maintenance shall not be considered as the spouse of the taxpayer.

(e) *Special rule for short sales by dealers in securities under certain circumstances.* In the case of a short sale of stock (as defined in subparagraph (3) of this paragraph) after December 31, 1957, by a dealer in securities, section 1233(e)(4)(A) provides that the holding period of substantially identical stock which he has held as an investment for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) shall be determined in accordance with section 1233(b)(2) unless such short sale is closed within 20 days of the date on which it was made. See rule (2) in paragraph (c)(2) of this section for the purpose of determining the holding period of such substantially identical stock. In addition, section 1233(e)(4)(B) provides that for the purpose of the special rule of section

1233(e)(4)(A), the acquisition of an option to sell property at a fixed price shall be considered a short sale, and the exercise or failure to exercise such option shall be considered a closing of such short sale. For purposes of this paragraph:

(1) Whether or not a taxpayer is a *dealer in securities* shall be determined in accordance with the meaning of the term for purposes of section 1236;

(2) Whether or not stock is *substantially identical* with other property shall be determined in accordance with the provisions of paragraph (d)(1) of this section; and

(3) The term *stock* means:

(i) Any share or certificate of stock,  
 (ii) Any bond or other evidence of indebtedness which is convertible into a share or certificate of stock, and

(iii) Any evidence of an interest in, or right to subscribe to or purchase, any of the items described in subdivision (i) or (ii) of this subparagraph.

(f) *Arbitrage operations in stocks and securities and holding periods—(1) General rule.* (i) In the case of a short sale entered into as part of an arbitrage operation, rule (2) of paragraph (c)(2) of this section shall apply first to substantially identical property acquired for arbitrage operations and held by the taxpayer at the close of business on the day of the short sale. The holding period of substantially identical property not acquired for arbitrage operations shall be affected only to the extent that the amount of property sold short exceeds the amount of substantially identical property acquired for arbitrage operations and held by the taxpayer at the close of business on the day of the short sale.

(ii) If the substantially identical property acquired for arbitrage operations is disposed of without closing the short sale so that a net short position in assets acquired for arbitrage operations is created, a short sale in the amount of such net short position will be deemed to have been made on the day such net short position is created. Rule (2) of paragraph (c)(2) of this section will then apply to substantially identical property not acquired for arbitrage operations to the same extent as if the taxpayer, on the day such net short position is created, sold short an

amount equal to the amount of the net short position in a transaction not entered into as part of an arbitrage operation.

(iii) The following examples illustrate the application of rule (2) of paragraph (c)(2) of this section to arbitrage operations:

*Example 1.* On August 13, 1957, A buys 100 bonds of X Corporation for purposes other than arbitrage operations. The bonds are convertible at the option of the bondholders into common stock of X Corporation on the basis of one bond for one share of stock. On November 1, 1957, A sells short 100 shares of common stock of X Corporation in a transaction identified and intended to be part of an arbitrage operation and on the same day buys another 100 bonds of X Corporation in a transaction identified and intended to be part of the same arbitrage operation. The bonds acquired on both August 13, 1957, and November 1, 1957, are, on the basis of all the facts and circumstances, substantially identical to the common stock of X Corporation. On December 1, 1957, A closes the short sale with 100 shares of common stock of X Corporation acquired on that day. The holding period of the bonds acquired on November 1, by application of rule (2) of paragraph (c)(2) of this section, will be deemed to begin on December 1 and the holding period of the bonds acquired on August 13 will be unaffected. If, instead of purchasing the 100 shares of common stock of X Corporation on December 1, 1957, A had converted the bonds acquired on November 1 into common stock and, on December 1, 1957, used the stock so acquired to close the short sale, rule (2) of paragraph (c)(2) of this section would similarly have no effect on the holding period of the bonds acquired on August 13.

*Example 2.* Assume the same facts as in example (1), except that A, on December 1, sells the bonds acquired on November 1 (or converts such bonds into common stock and sells the stock), but does not close the short sale. The sale of the bonds (or stock) creates a net short position in assets acquired for arbitrage operations which is deemed to be a short sale made on December 1. Accordingly, the holding period of the bonds acquired on August 13 will, by application of rule (2) of paragraph (c)(2) of this section, begin on the date such short sale is closed or on the date of sale, gift, or other disposition of such bonds, whichever date occurs first.

(2) *Right to receive or acquire property.*

(i) For purposes of section 1233(f) (1) and (2) and subparagraph (1) of this paragraph, a taxpayer will be deemed to hold substantially identical property acquired for arbitrage operations at the close of any business day if, by

virtue of the ownership of other property acquired for arbitrage operations (whether or not substantially identical) or because of any contract entered into by the taxpayer in an arbitrage operation, he then has the right to receive or acquire such substantially identical property.

(ii) The application of section 1233(f)(3) and subdivision (i) of this subparagraph may be illustrated by the following example:

*Example:* A acquires on August 13, 1957, 100 shares of common stock of X Corporation for purposes other than arbitrage operations. On November 1, A sells short, in a transaction identified and intended to be part of an arbitrage operation, 100 shares of X common stock. On the same day, in a transaction also identified and intended to be part of the same arbitrage operation, A contracts to purchase 100 shares of preferred stock of X. The preferred stock of X may be converted into common stock of X on the basis of one share of preferred stock for one share of common stock. The preferred stock is not actually delivered to A until November 3. Since A has contracted before the close of business on the date of the short sale, as part of an arbitrage operation, to purchase property by virtue of which he has the right to receive or acquire substantially identical property to that sold short, he will be deemed, for purposes of section 1233(f) (1) and (2), to hold such substantially identical property at the close of business on the date of the short sale. For purposes of this subparagraph, it is immaterial whether, on the basis of all the facts and circumstances, the preferred stock of X is substantially identical to the common stock of X. The short sale on November 1 does not affect the holding period of the 100 shares of X Corporation common stock purchased on August 13, 1957. Because of the operation of rule (2) of paragraph (c)(2) of this section, the holding period of the preferred stock acquired as the result of A's contract to purchase it as part of an arbitrage operation (or the common stock which A acquires by conversion of such preferred stock into common stock) will not begin until the short sale entered into in the arbitrage operation is closed.

(3) *Definition of arbitrage operations.*

For the purpose of section 1233(f), arbitrage operations are transactions involving the purchase and sale of property entered into for the purpose of profiting from a current difference between the price of the property purchased and the price of the property

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sold. Assets acquired for arbitrage operations include only stocks and securities and rights to acquire stocks and securities. The property purchased may be either identical to the property sold or, if not so identical, such that its acquisition will entitle the taxpayer to acquire property which is so identical. Thus, the purchase of bonds or preferred stock convertible, at the holder's option, into common stock and the short sale of the common stock which may be acquired therefor, or the purchase of stock rights and the short sale of the stock to be acquired on the exercise of such rights, may qualify as arbitrage operations. A transaction will qualify as an arbitrage operation under section 1233(f) only if the taxpayer properly identifies the transaction as an arbitrage operation on his records as soon as he is able to do so. Such identification must ordinarily be entered in the taxpayer's records on the day of the transaction. Property acquired in a transaction properly identified as part of an arbitrage operation is the only property which will be deemed acquired for an arbitrage operation. The provisions of section 1233(f) and this paragraph shall continue to apply to property acquired in a transaction properly identified as an arbitrage operation although, because of subsequent events, e.g., a change in the value of bonds so acquired or of stock into which such bonds may be converted, the taxpayer sells such property outright rather than using it to complete the arbitrage operation.

(4) *Effective date of section 1233(f)*. Section 1233(f), relating to arbitrage operations involving short sales of property, is effective only with respect to taxable years ending after August 12, 1955, and only with respect to short sales made after such date.

[T.D. 6500, 25 FR 12011, Nov. 26, 1960, as amended by T.D. 6494, 25 FR 9372, Sept. 30, 1960; T.D. 6926, 32 FR 11468, Aug. 9, 1967; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

## § 1.1233-2 Hedging transactions.

The character of gain or loss on a short sale that is (or is identified as being) part of a hedging transaction is determined under the rules of § 1.1221-2.

[T.D. 8555, 59 FR 36367, July 18, 1994]

## 26 CFR Ch. I (4-1-14 Edition)

### § 1.1234-1 Options to buy or sell.

(a) *Sale or exchange*—(1) *Capital assets*. Gain or loss from the sale or exchange of an option (or privilege) to buy or sell property which is (or if acquired would be) a capital asset in the hands of the taxpayer holding the option is considered as gain or loss from the sale or exchange of a capital asset (unless, under the provisions of subparagraph (2) of this paragraph, the gain or loss is subject to the provisions of section 1231). The period for which the taxpayer has held the option determines whether the capital gain or loss is short-term or long-term.

(2) *Section 1231 transactions*. Gain or loss from the sale or exchange of an option to buy or sell property is considered a gain or loss subject to the provisions of section 1231 if, had the sale or exchange been of the property subject to the option, held by the taxpayer for the length of time he held the option, the sale or exchange would have been subject to the provisions of section 1231.

(3) *Other property*. Gain or loss from the sale or exchange of an option to buy or sell property which is not (or if acquired would not be) a capital asset in the hands of the taxpayer holding the option is considered ordinary income or loss (unless under the provisions of subparagraph (2) of this paragraph, the gain or loss is subject to the provisions of section 1231).

(b) *Failure to exercise option*. If the holder of an option to buy or sell property incurs a loss on failure to exercise the option, the option is deemed to have been sold or exchanged on the date that it expired. Any such loss to the holder of an option is treated under the general rule provided in paragraph (a) of this section. In general, any gain to the grantor of an option arising from the failure of the holder to exercise it, and any gain or loss realized by the grantor of an option as a result of a closing transaction, such as repurchasing the option from the holder, is considered ordinary income or loss. However, for the treatment of gain or loss from a closing transaction with respect to or gain on the lapse of an option granted in stock, securities, commodities or commodity futures, see