accordance with paragraph (a) of this section. If, on the other hand, they make separate returns in 1955 following a joint return in 1954 in which their net capital loss was $5,000 allocable $3,000 to H and $2,000 to W, the carryover of H as a short-term capital loss for the purpose of his 1955 separate return would be $3,000 and that of W for her separate return would be $2,000, each allowable in accordance with paragraph (a) of this section.

Example 2. H and W, husband and wife, make separate returns for 1966 following a joint return for 1965. The capital gains and losses incurred by H and W in 1965, including those carried over by them to 1965, were as follows:

	H	W
Long-term capital gains	$8,000	$9,000
Long-term capital losses	(15,000)	(6,000)
Short-term capital gains	10,000	4,000
Short-term capital losses	(19,000)	(5,000)

Thus, in 1965 H and W had a net capital loss of $14,000 on their joint return. Of this amount, $4,000 was a long-term capital loss carryover, and $10,000 was a short-term capital loss carryover, determined in accordance paragraph (b) of this section. H's net long-term capital loss was $7,000 for 1965. This amount was offset on the joint return by W's net long-term capital gain of $3,000. Thus, H may carry over to his separate return for 1966, a long-term capital loss carryover of $4,000. H and W may carry over to their separate returns for 1966, as short-term capital loss carryovers, the amounts of their respective net short-term losses from 1965, $9,000 and $1,000.

[T.D. 6828, 30 FR 7806, June 17, 1965, as amended by T.D. 6867, 30 FR 15095, Dec. 7, 1965; T.D. 7301, 39 FR 968, Jan. 4, 1974; 39 FR 2758, Jan. 24, 1974; T.D. 7659, 44 FR 73019, Dec. 17, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

General Rules for Determining Capital Gains and Losses

§ 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 of 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.

[T.D. 6500, 25 FR 12003, Nov. 26, 1960, as amended by T.D. 7369, 40 FR 29840, July 16, 1975]

§ 1.1221–2 Hedging transactions.

(a) *Treatment of hedging transactions*—(1) *In general.* This section governs the treatment of hedging transactions under section 1221(a)(7). Except as provided in paragraph (g)(2) of this section, the term capital asset does not include property that is part of a hedging transaction (as defined in paragraph (b) of this section).

(2) *Short sales and options.* This section also governs the character of gain or loss from a short sale or option that is part of a hedging transaction. Except as provided in paragraph (g)(2) of this section, gain or loss on a short sale or option that is part of a hedging transaction (as defined in paragraph (b) of this section) is ordinary income or loss.

(3) *Exclusivity.* If a transaction is not a hedging transaction as defined in paragraph (b) of this section, gain or loss from the transaction is not made ordinary on the grounds that property involved in the transaction is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose.

(4) *Coordination with section 988.* This section does not apply to determine the character of gain or loss realized on a section 988 transaction as defined in section 988(c)(1) or realized with respect to any qualified fund as defined in section 988(c)(1)(E)(iii).

(b) *Hedging transaction defined.* Section 1221(b)(2)(A) provides that a hedging transaction is any transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily—

(1) To manage risk of price changes or currency fluctuations with respect to ordinary property (as defined in paragraph (c)(2) of this section) that is held or to be held by the taxpayer;

(2) 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

(3) To manage such other risks as the Secretary may prescribe in regulations (see paragraph (d)(6) of this section).

(c) *General rules*—(1) *Normal course.* Solely for purposes of paragraph (b) of this section, if a transaction is entered into in furtherance of a taxpayer's trade or business, the transaction is entered into in the normal course of the taxpayer's trade or business. This rule includes managing risks relating to the expansion of an existing business or the acquisition of a new trade or business.

(2) *Ordinary property and obligations.* Property is ordinary property to a taxpayer only if a sale or exchange of the