

partnership that occur on or after September 21, 2000.

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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 destruction, 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 taken into account in applying the pro-

visions 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 |
| 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

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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.

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§ 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

(ii) For 12 months or more from the date of acquisition in the case of such other livestock.

(2) In the case of livestock (including cattle or horses) acquired by the taxpayer on or before December 31, 1969, section 1231 applies to the sale, exchange, or involuntary conversion of such livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition.

(3) For the purposes of section 1231, the term *livestock* is given a broad, rather than a narrow, interpretation and includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. However, it does not include poultry, chick-

ens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc.

(b)(1) Whether or not livestock is held by the taxpayer for draft, breeding, dairy, or sporting purposes depends upon all of the facts and circumstances in each case. The purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal. However, a draft, breeding, dairy, or sporting purpose may be present if an animal is disposed of within a reasonable time after its intended use for such purpose is prevented or made undesirable by reason of accident, disease, drought, unfitness of the animal for such purpose, or a similar factual circumstance. Under certain circumstances, an animal held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business may be considered as held for draft, breeding, dairy, or sporting purposes. However, an animal is not held by the taxpayer for draft, breeding, dairy, or sporting purposes merely because it is suitable for such purposes or merely because it is held by the taxpayer for sale to other persons for use by them for such purposes. Furthermore, an animal held by the taxpayer for other purposes is not considered as held for draft, breeding, dairy, or sporting purposes merely because of a negligible use of the animal for such purposes or merely because of the use of the animal for such purposes as an ordinary or necessary incident to the other purposes for which the animal is held. See paragraph (c) of this section for the rules to be used in determining when horses are held for racing purposes and, therefore, are considered as held for sporting purposes.

(2) The application of this paragraph is illustrated by the following examples:

Example 1. An animal intended by the taxpayer for use by him for breeding purposes is discovered to be sterile or unfit for the breeding purposes for which it was held, and is disposed of within a reasonable time thereafter. This animal is considered as held for breeding purposes.

Example 2. The taxpayer retires from the breeding or dairy business and sells his entire herd, including young animals which would have been used by him for breeding or dairy purposes if he had remained in business. These young animals are considered as