Welcome

Welcome to the Capital Gains and Losses course.

This CPE course, developed by the CCH Editorial Staff, provides you with an overview of the key concepts and tax consequences of transactions involving capital gains and losses.

We will discuss the basic rules and what you can do to take maximum advantage of them.

To help you further research this topic, links from cited documents (e.g., sections from the Internal Revenue Code and regulations, cases, etc.) to the full text of such documents are provided within CCH Learning Center courses.

You must be a subscriber to the CCH Tax Research NetWork to take advantage of this powerful content integration functionality.

Visit cchgroup.com for more information about the CCH Tax Research NetWork and how to subscribe.
Course Structure

How the Course is Organized

This course is designed to provide you with an engaging learning experience. It consists of self-paced reading materials, study questions, observations, examples, and illustrations.

Capital Gains and Losses is divided into the following chapters:

- Capital Gains and Losses
- Gains and Losses on Code Sec. 1231 Assets
- Recapture of Deductions
- Special Rules

Why Do I Need to Complete Learning Activities?

Integrated throughout the course are study questions that give you the opportunity to test your understanding of the material presented and to prepare you for the Final Exam. Answering the questions encourages interactivity and reinforces the course objectives.

What Do I Find in the Glossary?

A glossary section provides definitions of the terms used in the text. It is universal for all CCH Learning Center online courses. Terms are listed in alphabetical order.

How to Navigate the Site

The Back arrow ( ) and Next arrow ( ) allow you to navigate linearly through the course. The drop down list in the upper left allows you to select which lesson you want to view. When you select a lesson, the topics and pages within that lesson appear in the left navigation frame. After you have visited a page, the title in the left navigation frame will be grayed out. Furthermore, the Course Outline in the menu bar lists all lessons, topics, and subtopics in a comprehensive outline, allowing you to link directly to any page in the course.

CCH Tax Research NetWork

Most modules in this course include links to the CCH Tax Research NetWork, providing access to relevant sections of the Internal Revenue Code ("the Code") and Treasury regulations. Direct links to the selections are provided. You will need to use your personal CCH Tax Research NetWork User ID and Password.

There are different ways you can use the CCH Tax Research NetWork in this course:

- Read online when directed.
- Access the CCH Tax Research NetWork, print the pages, read the hard copy, and take notes.
- Keep the CCH Tax Research NetWork open during the course and toggle back to it when necessary.
NOTE: You need to log in to the CCH Tax Research NetWork only once. Each time you click on a link, a new Internet Explorer window will open. You can have several Code sections and regulations open at once, each in its own window.
Introduction


As a result, converting ordinary income into capital gain can be rewarded by significant tax savings.

Because of rate cuts introduced by JGTRRA 2003, the spread between ordinary income rates and capital gains rates is now larger than ever: going from 38.6 percent ordinary rates and 20 percent capital gains rates before JGTRRA to 35 percent and 15 percent now.

Year-end tax planning should include a careful look at how you manage your net capital gains or losses for the rest of the year.

Keep in mind that 2003 was the "transition" year for capital gains in which some gains were taxed at 20 percent, some at the new 15 percent rate, and some as qualified dividends, but for gain purposes only.

This course will provide the user with an understanding of the Code sections governing the tax treatment of capital gains and losses, and provide a working understanding of how these rules operate.

It will also review recent legislation that affects the tax treatment of capital gains.
Course Objectives

This course was prepared to enable participants to attain a basic level of knowledge in the area of capital gains and losses. More specifically, upon course completion, you will be able to:

Learning Objectives

- Understand and apply the basic concepts of federal taxation regarding capital gains and losses.
- Understand the changes affecting the tax treatment of capital gains and losses resulting from JGTRRA 2003 and other legislation.
- Answer client questions regarding gains and losses with accuracy and confidence.
Tools and Resources

In addition to insights from examples and observations throughout this course, **Tools and Resources** are provided to:

- Keep you abreast of developments in capital gains and losses.
- Help you apply the knowledge gained from this course in your practice.
- Help you generate fees in this growing area of accounting.

Subscribers to **CCH Internet Tax Research NetWork** also have the option of receiving news headlines and summaries related to **capital gains and losses** directly to their desktop through e-mail. Coverage includes daily news stories, full text of primary source documents cited, and an optional daily e-mail.

☑ Sign up for customized news feeds from [CCH Tax Tracker](#).

You will need Acrobat Reader to view or print the following articles and forms in Portable Documents (PDF). If you need to install it, download the free plugin from [Adobe’s website](#).

**Download:**

☑ **Capital Assets and Noncapital Assets**

This publication outlines items that are considered capital assets and those that are noncapital. It provides a convenient reference using a list format to show the differences between the two.

☑ **Client Letter: Holding Period for Capital Assets**

You can customize this letter to give your clients a better understanding of the importance of holding period to your investment strategy, as well as how to measure holding period for federal income tax purposes.
Capital Gains and Losses

Capital or Ordinary

Gain or loss that results from the sale or exchange of property is characterized as either capital or ordinary.

It is important to correctly determine the character of a gain or loss because capital gains and losses are treated differently under the tax law than ordinary gains and losses.

Tax Treatment of Capital Gains or Losses

As a general rule, capital gains are treated more favorably under the Internal Revenue Code than ordinary gains.

This preferential treatment is intended to act as an inducement to taxpayers to purchase certain assets or to make investments.

However, this favorable tax treatment is bestowed only on what are called long-term capital gains.

In order to be classified as a long-term capital gain, the taxpayer must hold the property that gave rise to the gain for more than 12 months.

In addition, to receive preferential tax treatment, the taxpayer's net long-term capital gains must have exceeded capital losses.

While capital gains are treated more favorably than ordinary gains, deductions for capital losses are subject to more restrictions than ordinary losses.

Capital Assets

Capital gains and losses arise from the sale or exchange of capital assets. Ordinary income or loss arises from the sale or exchange of noncapital assets. The character of a gain or loss depends upon the character of the asset that was disposed of.

For individuals, everything that is owned and used for personal purposes, pleasure, or investment is a capital asset. Thus, an individual’s home, shares of stock, car, and jewelry are capital assets.

However, it is important to know that while property held by an individual for pleasure or personal use is a capital asset, losses from the sale or exchange of such property are not deductible.

For example, an individual may realize a capital loss when he sells his home, but the loss will not be recognized for tax purposes.

Under the Code, the definition of capital assets includes all property held by a taxpayer except for certain types (Code Sec. 1221).

Thus, in order to determine if a particular asset is a capital asset, the practitioner should first consult the Code’s list of excluded items.

If the type of property is not listed, then the property is a capital asset. Among the noncapital assets mentioned in the Code are property held primarily for sale to customers (i.e., inventory), depreciable property, and real estate used in the taxpayer’s trade or business.
Special Rules

In some situations, property that is excluded from the definition of a capital asset under the general rules of the Code may be treated as a capital asset under other Code provisions. These special provisions apply to certain types of business property.

In order to prevent a business taxpayer from receiving a double tax advantage by first being able to claim depreciation on a business asset and then being able to characterize all the gain realized on the sale as capital gain, the Code imposes certain recapture provisions.

These recapture provisions generally require a business taxpayer to classify the portion of the gain that represents the amount of depreciation that had been claimed on a non-real estate asset as ordinary income and the remaining portion of the gain, if any, as capital gain.

Because investment property is characterized as a capital asset and business property may not be so classified, the Code contains rules to prevent taxpayers from misclassifying business property as investment property.

Other rules intended to prevent the conversion of ordinary income to capital gain include:

- Provisions treating gain on the disposition of tax-exempt bonds and market discount bonds issued on or before July 18, 1984 that are acquired for less than the principal amount of the bond, as ordinary income rather than capital gain to the extent of accrued market discount.
- Rules that treat amounts received by a partner for a partnership interest as ordinary income to the extent they are attributable to unrealized receivables and substantially appreciated inventory held by the partnership.
- An election that allows taxpayers to include capital gain in computing the limitation on the investment interest deduction if they reduce the amount of income taxed at capital gain rates by this amount.

Elements of Capital Gains and Losses

There are two essential elements of a capital gain or loss:

- First, a capital gain or loss arises only if there is a "sale" or an "exchange."
- Second, a "capital asset" must actually be sold or exchanged.

A sale or an exchange of a noncapital asset usually results in ordinary income or loss.

The capital gain and loss provisions do not tax gains that are not otherwise taxable under the law, nor do they allow deduction of losses that are not otherwise deductible.

Capital gain or loss results from the sale or exchange of a capital asset. However, not all sales or exchanges of capital assets result in capital gain or loss.

Some or all of the gain from the sale of certain capital assets may be taxable as ordinary income in order to prevent a taxpayer from converting what should be ordinary income into capital gains.

Furthermore, certain assets such as Code Sec. 1231 assets, while not technically capital assets, may be entitled to modified capital gain treatment.

For noncorporate taxpayers, the maximum rate of the alternative minimum tax (AMT) on net capital gain is limited (Code Sec. 55(b)(3)), as it is limited for regular income tax purposes (Code Sec. 1(h)).
Since May 5, 2003, the maximum capital gains rate has been generally either 5 percent or 15 percent, depending on the taxpayer's highest marginal tax bracket (Code Sec. 1(h)(1)). Higher capital gains tax rates may apply to certain types of gains. For example, long-term capital gains from collectibles may be subject to a capital gains tax rate as high as 28 percent.

When computing a noncorporate taxpayer's AMT, part of the process requires that a determination be made as to what portion of the adjusted net capital gain is eligible to be taxed at 5 percent for AMT purposes (Code Sec. 55(b)(3)).

A change to the required AMT computation (Code Sec. 55(b)(3)(B)) was made by the Working Families Tax Relief Act of 2004 (WFTRA).

Under this change, the maximum amount of adjusted net capital gain eligible for the 5 percent rate is the excess of the maximum taxable income that may be taxed at a rate of less than 25 percent under the regular tax (i.e., $63,700 on a 2007 joint tax return) over taxable income reduced by the adjusted net capital gain.

Both net short-term and net long-term capital losses are combined for purposes of offsetting ordinary income. Only up to $3,000 of capital losses can be deducted against ordinary income by noncorporate taxpayers.

Corporations are not allowed capital loss offsets against ordinary income. Both net long-term capital losses and net short-term capital losses may be used to offset up to $3,000 of ordinary income of a noncorporate taxpayer.

Example: An individual taxpayer has $20,000 of ordinary income, a net short-term capital loss of $500 and a net long-term capital loss of $300. The taxpayer's capital loss deduction is $800, the full sum of both losses.

Example: An individual taxpayer has a long-term capital gain of $60,000, a long-term capital loss of $10,000, and no short-term capital gains or losses. The taxpayer has a net capital gain of $50,000, all of which is includible in gross income.

An alternative tax is imposed on corporate net capital gains. The alternative tax on corporate capital gains is 35 percent.

The alternative minimum tax rate of 35 percent is applied to the lesser of either the corporation's net capital gain or its taxable income (Code Sec. 1201(a)).

However, because the alternative minimum tax rate only applies when a corporation's ordinary income tax rate exceeds 35 percent, and the top corporate tax rate is currently 35 percent, this rule has no immediate impact on corporations.

Before 2003, long-term capital gains were taxed at rates of 20 percent or 10 percent, depending on the taxpayer's income tax bracket. In addition, if the taxpayer held the asset for at least five years, the rates were lowered.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA 2003), which was enacted on May 28, 2003, lowered income tax rates to 25 percent, 28 percent, 33 percent and 35 percent for tax years beginning after December 31, 2002. (Income tax rates of 10 percent and 15 percent are still applicable for taxable income below certain levels.)
JGTRRA 2003 also **eliminated the five-year special holding period rule** that previously allowed individuals to avail themselves of lower capital gains rates.

Thus, depending on the nature of the asset and the applicable ordinary income tax bracket, **individuals, estates, and trusts** are now generally subject to maximum rates of 15 percent (if taxed at the 25 percent or higher marginal rates) and 5 percent (if taxed at the 15 percent or 10 percent bracket) on net capital gains (the excess of net long-term capital gain over net short-term capital loss).

For taxpayers in the 10 percent and 15 percent brackets, the 5 percent rate is reduced to zero percent in 2008, 2009, and 2010.

These reduced capital gains rates apply to **sales or exchanges** occurring on or after May 6, 2003, and before January 1, 2011. After December 31, 2010, the lower rates on long-term capital gains will expire and the prior capital gains rates of 20 percent and 10 percent will be in effect.

**Noncorporate investors** continue to be allowed an exclusion of up to 50 percent of the gain they realize on the disposition of qualified small business stock issued after August 10, 1993 and held for more than five years, subject to per-issuer limitations (**Code Sec. 1202**).

**Gains on the sale of collectibles** are subject to a maximum 28 percent rate. Further, some portions of gain on **Code Sec. 1250** property are subject to a maximum rate of 25 percent. Any net short-term capital gain is taxed at the ordinary income tax rates, including the top 35 percent rate.

As is the case with ordinary income tax rates, persons in higher income tax brackets may find that the actual tax paid is disproportionately higher in relation to the stated tax rates on net capital gains.

This is because the effects of the **personal exemption phaseout** and the **itemized deduction limitation threshold** may indirectly increase the percentage of the net capital gain taxed.

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**Example:** If a couple filing a joint return for tax year 2007, with a $297,500 long-term 15 percent rate capital gain; no other income; and itemized deductions of $20,000 was to contemplate a sale that would result in an additional $2,500 in long-term 15 percent rate capital gain, their additional capital gain would also be taxed at 15 percent, rather than at 33 percent.

However, their itemized deductions would be decreased by $4,308 (3 percent of adjusted gross income over $156,400) after calculating the reduction of itemized deductions for high-income taxpayers, and their personal exemptions would be decreased by $3672 (54 percent of two personal exemptions at $3,400 each).

As a result, their tax liability would be increased, and their effective tax rate on the additional long-term capital gain would be more than 15 percent.

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Note that in tax years beginning after December 31, 2005, the limit on itemized deductions for high-income taxpayers will be phased out until it is fully repealed effective for tax years beginning after 2009.
Sale or Exchange Required

The capital gain and loss provisions apply only when there is a sale or exchange of a capital asset (Code Sec. 1222; Reg. §1.1222-1).

The Code makes no distinction between a sale and an exchange. Both are treated in the same manner for capital gain and loss purposes.

With some exceptions, noted below, the terms "sale" and "exchange" have the same meanings for income tax purposes as they do in everyday business transactions.

For example, a sale is generally a transfer of property for money, or a mortgage, note or other promise to pay money. An exchange is a transfer of property for other property or services, and may be taxed in the same way as a sale. In some cases when there has been an actual sale or exchange of a capital asset or business property eligible for capital gain treatment, the transaction does not result in a capital gain.

For example, capital gain does not result from the sale or exchange of depreciable property between related persons.

Gain from the sale or disposition of cost recovery or depreciable real or personal property is treated as ordinary income to the extent of allowable cost recovery or depreciation deductions.

In other cases, transactions involving apparent sales or exchanges of capital assets or business property have been determined not to involve a sale or exchange.

The abandonment of property by a trustee during the pendency of a bankruptcy estate is not a sale or exchange of assets that gives rise to a tax liability chargeable to the bankruptcy estate.

There are a number of transactions that are treated as a sale or exchange for tax purposes, although they would ordinarily not be considered such.

These transactions include:

- Bond retirement
- Certain liquidation distributions
- Worthless securities
- Failure to exercise privileges or options
- Involuntary conversions and regulated futures contracts
- Certain mixed straddles

Casualty Loss

Destruction of property by fire, storm, or any other casualty is treated as a sale or exchange of a capital asset.

Gains and losses from personal casualties and thefts are separately netted, since such losses are deductible only as itemized deductions.

Net casualty losses are also subject to a $100 floor and are deductible only to the extent that the losses exceed 10 percent of the taxpayer’s adjusted gross income.
If the recognized gains exceed recognized losses, then all such gains and losses are treated as capital gains.

If the recognized losses exceed the recognized gains (as when a property is insured for more than the taxpayer's basis), then all gains and losses are ordinary.

Later sections of this course will discuss the treatment of gains and losses that result from the destruction of business property.

### Nonbusiness Bad Debt

Nonbusiness bad debts may be deducted by taxpayers other than corporations only as short-term capital losses, regardless of the age of the debt (Code Sec. 166(d)).

No deduction is permitted, however, unless and until the debt becomes totally worthless.

### Foreclosure

The term "sale" includes a forced sale as well as a voluntary sale. Thus, a foreclosure sale of the taxpayer's property has been held to be a sale by the taxpayer within the meaning of the capital gain or loss provisions.

This is true even though there is no personal liability of the taxpayer, as in the case of a purchase money mortgage in many states, and also as in the case of a tax lien in most states.

Thus, where the taxpayer's property is sold for unpaid real estate taxes—for which the taxpayer was not personally liable—and the taxpayer received no consideration for the transfer on foreclosure, there was a sale for purposes of the capital gain or loss provisions.

The gain recognized can also include any liabilities that a taxpayer is discharged from as a result of a foreclosure.

### Voluntary Surrender by Equity Owner

In the case of a voluntary conveyance of property by the equity owner to the mortgagee instead of a foreclosure, the transaction is still a sale or exchange as to the equity owner whether or not the individual transferring the property is personally liable on the mortgage.

The equity owner may also realize ordinary income from cancellation of debt if the loan balance is more than the fair market value of the property.

### Effects from Standpoint of Mortgagee

A foreclosure sale at which the mortgagee bids on the property is treated by the mortgagee as an exchange of the debtor's obligation for the property. Therefore, if the obligation is a capital asset, a sale or an exchange of a capital asset has taken place.

Any deficiency judgment, to the extent it is not collectible, is treated as a bad debt (Reg. § 1.166-6).
**Condemnation Awards**

In the case of property taken in a condemnation proceeding, the transaction is regarded as a sale.

Thus, the taxpayer determines gain or loss by **comparing the adjusted basis of the condemned property with the net condemnation award**.

In addition, the taxpayer may postpone reporting gain from a condemnation if he or she buys replacement property.

If the condemning authority pays interest for its delay in paying an award, this amount is not a part of the sale price. Rather, it is ordinary income in the nature of interest and must be reported separately.

**Lease Cancellation**

Amounts received by a lessee for cancellation of a lease are **amounts received in exchange for the lease** *(Code Sec. 1241; Reg. §1.1241-1)*.

If the lease is a capital asset, then the lessee will have a capital gain or a capital loss on cancellation of the lease. Leasehold interests are regarded as capital assets.

The amount paid by a sublessee to a lessee for the release of all rights and interests under the lease to enable the sublessee to have a more direct arrangement with the owner of some real property results in a capital gain to the lessee.

Payments received by a landlord from a tenant for the cancellation of a lease are ordinary income. They are considered to be in lieu of rent.

**Capital Assets Defined**

A capital asset, as defined under *Code Sec. 1221* and *Reg. §1.1221-1*, includes all property held by a taxpayer (whether or not connected with a trade or business), with the following exceptions:

- Inventoriable assets
- Property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business
- Depreciable business property subject to the rules described in *Code Sec. 1231*
- Real estate used in the taxpayer's trade or business that also is subject to the rules described in *Code Sec. 1231*
- A copyright; literary, musical or artistic composition; letter or memorandum; or similar property, held by one of the following:
  - The person whose efforts created it
  - In the case of a letter, memorandum, or similar property, held also by a person for whom the property was prepared or produced
  - A transferee whose basis is computed by reference to that of the person creating it, or, in the case of a letter, memorandum, or similar property, also by a taxpayer for whom such property was prepared or produced
  - Note: In tax years beginning after May 17, 2006, taxpayers may elect to treat certain musical compositions or copyrights as capital assets.
- Accounts or notes receivable acquired in the ordinary course of business for services rendered or sale of stock in trade (first two classes above)
U.S. government publications (including the Congressional Record) that are received by a taxpayer without charge or below the price at which they are sold to the general public or received by another taxpayer in whose hands the publication would have a basis determined in whole or in part by reference to the taxpayer's basis.

The word "primarily," as used above, means "principally" or "of first importance." Thus, property held principally to realize appreciation in value over a substantial period of time is classified as a capital asset even where similar property could be used in a trade or business.

According to the Supreme Court, capital asset treatment cannot be avoided unless the property falls within one of the exceptions listed above.

Most types of "nonbusiness" property, such as stocks, bonds, residences, personal automobiles, household furnishings, jewelry, boats, airplanes, etc., owned and used for personal or investment purposes, are capital assets.

Land and depreciable property used in a trade or business are not capital assets. However, if they are sold or exchanged, it is possible for the gain to be treated as gain from capital assets under Code Sec. 1231.

Minerals, ores, gas, oil and similar deposits, when they are sold in place, are capital assets. However, once they are removed and sold in units by the owner, their sale results in ordinary income.

Standing timber is a uniquely renewable resource that has been recognized as a capital asset by state real property laws. Standing timber that is neither used in a trade or business, nor held primarily for sale to customers in the ordinary course of a trade or business, is also a capital asset under federal income tax laws.

Under the American Jobs Creation Act of 2004 (AJCA), outright sales of standing timber after December 31, 2004, will qualify for capital gain treatment. The requirement that the owner of timber must retain an economic interest in the timber in order to obtain capital gain treatment does not apply to outright sales of timber (Code Sec. 631(b)).

Stocks and Securities

In Arkansas Best Corp., 485 US 212 (1988), the Supreme Court held that a taxpayer's motivation in purchasing an asset is irrelevant in determining whether it falls within the broad statutory definition of a "capital asset."

Thus, losses incurred by a diversified holding company from the sale of bank stock that had been purchased in order to supply new capital to the financially troubled institution were capital in nature.

In so ruling, the Court limited the scope of the Corn Products doctrine, which, since 1955, has been interpreted as creating a nonstatutory exception to the definition of a capital asset where the asset was purchased for ordinary business purposes and not as an investment.

The U.S. Supreme Court rejected the broad interpretation of Corn Products and now maintains that that decision stands only for "the narrow proposition that hedging transactions that are an integral part of a business's inventory-purchase system fall within" the exception of inventory as a capital asset.

Additionally, the Court points out that Code Sec. 1221 provides the only exceptions to the classification of capital assets.

However, in 1993, in Federal National Mortgage Assn., the Tax Court rejected the IRS's position and concluded that a mortgage association's business hedges resulted in ordinary gain or loss.
In response to these opinions, the IRS has agreed to the ordinary treatment of business hedges in its regulations (Reg. §1.1221-2).

**Sale of Business**

When a sole proprietorship's going business is sold (as distinguished from a sale of a partnership interest or of stock), the sale price must be apportioned among the various assets and the gain or loss on each asset must be computed and identified as capital or ordinary.

This rule applies also when only a part interest in a going business is sold.

The right to the use of a corporate name is a capital asset, as is goodwill.

**Holding Period: Determining Whether Gain Is Short-Term or Long-Term**

A capital gain or loss is "**long-term**" if the capital asset sold or exchanged is held for more than 12 months (Code Sec. 1222).

An asset held for **exactly 12 months** will not qualify for the 5 percent/15 percent maximum tax rate. The "**holding period**" is the length of time between the date on which the taxpayer acquires the property and the date on which he disposes of it.

The date of acquisition is not included in the holding period, but the date of sale is.

**Exceptions to the Rule**

There are some exceptions to the holding period rules under which the holding period of a former owner of property, or of previously held property, can be "**tacked on**" to the taxpayer's holding period in special cases.

These exceptions prolong the holding period: none of them shorten the period to less than the time the taxpayer held the asset.

**Property Acquired from a Decedent**

A person who sells or disposes of property acquired from a decedent will usually be treated as having held the property for the long-term capital gains holding period no matter how long the person acquiring the property or the decedent actually held it (Code Sec. 1223(11)).

Thus, the Code treats inherited property as property held for more than 12 months. To qualify, the property must have been acquired from the decedent within the terms of Code Sec. 1014(b). This encompasses property acquired by bequest, devise, inheritance, or by the decedent's estate from the decedent.

Thus, the sale of an asset by an executor or administrator will qualify for long-term gain treatment, as well as property that is distributed to a beneficiary.

The rule does not apply to property that an estate acquires or purchases after a decedent's death and then distributes to beneficiaries. In such a case, the beneficiary's holding period begins with the fiduciary's holding period.
Jointly owned property, community property, and other types of assets that are includible in the decedent's gross estate also qualify for long-term capital gains treatment (Reg. §1.1223-1(J)).

Specially valued property that is transferred to a qualified heir in satisfaction of a pecuniary bequest or that is purchased from the decedent's estate by a qualified heir is treated as meeting the holding period for long-term capital gain treatment upon a subsequent sale of the property to another qualified heir (Code Sec. 1223(12)).

**Property Exchanged or Converted**

A taxpayer's holding period for property received in an exchange ("new property") may include the period of time when he or she held another property ("old property") if the basis for the new property is determined with reference to the basis of the old property, as in the case of a tax-free exchange.

However, at the time of the exchange, the property exchanged must be a capital asset, a business asset, a business asset eligible for a capital gain, property acquired in an involuntary conversion transaction when gain or loss was not recognized, or stock or securities received in a spin-off (Code Sec. 1223(1); Reg. §1.1223-1).

**Example:** A taxpayer bought machinery on December 4, 2006. On June 4, 2007, the taxpayer traded this machinery for other machinery in a nontaxable exchange. On December 6, 2007, the taxpayer sold the machinery he received in the exchange.

The holding period for this machinery began on December 5, 2006. Therefore, the taxpayer held it longer than one year.

**Prior Holder**

In determining the period for which a taxpayer has held property where the basis is the same, in whole or in part, in the taxpayer's hands as in the hands of a prior holder, the period for which the property was held by the prior holder is included (Code Sec. 1223(2)).

Such property includes property acquired by gift and sold for more than the donor's cost or other basis and property acquired by transfer in trust.

**Example:** A taxpayer sold property for $2,500 on September 10, 2007. He had received it by gift from his father on July 8, 2007, and his father had received it by gift from another relative on April 5, 1975. The latter had bought it for $2,000 cash on September 4, 1974. The holding period for the September 10, 2007 sale began on September 5, 1974, making it long-term.

The donee's holding period begins with the date of the gift, where the value of the property on the date of the gift is less than the donor's basis and the donee disposes of the gift at less than the property's value at the date of the gift (Code Secs. 1015(a); 1223(2); Reg. §1.1223-1(b)).
Example: Assume the same facts as in the previous example, but suppose that the selling price was only $1,400, that the fair market value of the property at the time of the taxpayer's acquisition, July 8, 2007, was $1,600, and that no gift tax on the gift was due or paid.

In that case, there would be a loss and the basis would be $1,600. With the basis not being a substituted basis, the holding period dates from July 8, 2007, the actual date of acquisition. The loss is short-term. From the foregoing it may be said, "date basis" follows "dollar basis." In other words, the holding period begins on the date of the basis determination.

Disallowed Losses on Sales Between Related Interests

When a loss on a sale or exchange is disallowed because the sale was to a related taxpayer, and the buyer resells at a gain, the gain is recognized only to the extent that it exceeds the previously disallowed loss (Code Sec. 267(d)).

However, there is no transferred or substituted basis in this case, only a special provision for nonrecognition of a part of the gain, determined by reference to the cost basis of the property.

Therefore, the holding period in the hands of the owner who sustained the disallowed loss is not added to the related purchaser's holding period.

Example: Claire's sister, Elizabeth, sells Claire her XYZ, Inc. stock for $7,600. Elizabeth's cost basis in XYZ stock was $10,000. Elizabeth cannot deduct her $2,400 loss.

Later, Claire sells the same stock to an unrelated party for $10,500, realizing a gain of $2,900. Claire's recognized gain is $500: the $2,900 gain minus the $2,400 loss not allowed to Elizabeth.

It is important to note that the loss in the preceding example can only be recognized to the extent of the gain realized by the transferee (in the example, Claire). See Reg. §1.267(d)-1.

Example: Assume that in the example above Claire sells the stock to an unrelated party for $6,600. She has realized a loss of $1,000.

Her recognized loss is $1,000. The previously disallowed loss to Elizabeth is not recognized because it could have only been recognized to the extent of a gain realized by Claire (the transferee).
Tax Rates

For sales of long-term capital assets on or after May 6, 2003, generally the maximum capital gains rate is 15 percent (5 percent for taxpayers in the 10 percent or 15 percent tax bracket) (Code Sec. 1(h), as amended by P.L. 108-27).

In 2008, the 5 percent rate is reduced to zero.

The lower capital gains rates are effective for tax years ending on or after May 6, 2003, and beginning before January 1, 2011.

After December 31, 2010, the lower rates on long-term capital gains will "sunset" (expire), at which time the prior capital gain rates of 20 percent and 10 percent will become effective.

There are special transitional rules governing the treatment of long-term gains occurring before May 6, 2003.

Example: An individual, filing single, has $100,000 in income in 2007 from the sale of capital assets held for more than 12 months. This is her sole source of income for the year.

Since $28,400 of her taxable income is taxed at the 10 percent and 15 percent rates for regular tax purposes, the first $28,400 of her capital gain is taxed at the 5 percent rate.

The balance of her capital gain is taxed at 15 percent.

A special 28 percent tax applies to gain on the sale of collectibles held for more than 12 months.

Unrecaptured Code Sec. 1250 gain is subject to a maximum tax rate of 25 percent.

For tax years beginning after December 31, 2000, if certain requirements were met, the maximum rates on "qualified five-year gain" could be reduced to 18 percent and 8 percent, in place of 20 percent and 10 percent, respectively.

Under JGTRRA 2003, the 18 percent and 8 percent tax rates for qualified five-year gain are repealed.

However, when the 15 percent and 5 percent capital gains rates expire, the five-year holding period requirement and the 18 percent and 8 percent rates will be effective.

The 35 percent rate that applies to capital gains of corporations was not affected by JGTRRA 2003.

Combining Capital Gains and Losses

The following steps must be applied in determining the tax treatment for capital gains and losses (Code Sec. 1222; Reg. §1.1222-1).

- The capital gains and losses are segregated into those that are short-term and those that are subject to the 15/5, 25, and 28 percent tax rates.
The short-term gains and losses are netted. The result is called either a net short-term capital gain or a net short-term capital loss.

A net short-term capital loss is then applied first to reduce any long-term capital gain from the 28 percent group, then gain from the 25 percent group, and then from the 15/5 percent group.

A net loss from the 28 percent group is applied first to reduce any gain from the 25 percent group and then from the 15/5 percent group.

A net loss from the 15/5 percent group is applied first to reduce any gain from the 28 percent group and then from the 25 percent group.

### Individual’s Net Capital Loss Carryovers

Individuals and other noncorporate taxpayers may carry over a net capital loss for an unlimited time period until the loss is exhausted.

A capital loss carried over to a later tax year retains its long-term or short-term character for the year to which it is carried (Code Sec. 1212(b)(1)).

A short-term capital loss carryover offsets short-term gain first in the carryover year.

If a net short-term capital loss results, this loss offsets long-term capital gain as set forth above and up to $3,000 of ordinary income on a dollar-for-dollar basis.

**Example:** Mitchell Blass has taxable income of $30,000 in 2007 and files a joint return. In computing his taxable income, he reported a net short-term capital loss of $1,000 and a net long-term capital loss of $5,000.

Mitchell would use his $1,000 net short-term loss to offset $1,000 of ordinary income. He would use $2,000 of his net long-term capital loss to offset $2,000 more of his ordinary income.

The remaining $3,000 of his net long-term capital loss would be carried over to 2008. It should be noted that all long-term capital losses are carried forward as 28 percent losses.

### Corporation’s Capital Loss Treatment

A corporation can use its capital losses only to offset capital gains (Code Sec. 1211(a)).

If, however, a corporation’s capital losses exceed its capital gains, the net loss is available for a limited carryback and carryover.

**Example:** A corporation had the following capital gains and losses in the tax year:

<table>
<thead>
<tr>
<th>Capital Gain/Loss</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term capital gains</td>
<td>$1,000</td>
</tr>
<tr>
<td>Long-term capital losses</td>
<td>2,000</td>
</tr>
<tr>
<td>Short-term capital gains</td>
<td>1,000</td>
</tr>
<tr>
<td>Short-term capital losses</td>
<td>500</td>
</tr>
</tbody>
</table>
The corporation has a net long-term capital loss of $1,000 and a net short-term capital gain of $500. Of the net long-term capital loss, $500 may be offset against the net short-term capital gain of $500.

The remainder cannot be deducted in the tax year but is available for carryback and carryover.

### Capital Loss Carrybacks and Carryovers

Any excess of capital losses that is not used up in the tax year may be carried back to each of the three tax years preceding the loss year, beginning with the earliest year and then forward up to five years following the loss year.

The carryback and the carryover can be used to offset capital gain net income in the years to which the loss is carried.

However, any undeducted loss remaining after the three-year carryback and five-year carryover periods is lost as a deduction.

The amount that can be carried back is further limited to an amount that does not cause or increase a net operating loss in the carryback year.

Unlike noncorporate taxpayers, corporate carryovers are treated as short-term losses in the year to which they are carried.

#### Example:

In 2007, a corporation had an excess of capital losses over capital gains, after offsetting long-term and short-term gains and losses against each other, in the amount of $6,300.

None of this $6,300 is deductible against 2007 ordinary income. There is a $6,300 capital loss carryback to 2004, 2005, and 2006, to be treated as a short-term loss in each of these years.

To the extent that there is insufficient capital gain net income in each of these years to absorb the loss carryback, it can be carried over to 2008, again to be treated as a short-term capital loss.

It can be offset in 2008 against capital gains, both long-term and short-term, but it must offset short-term gains first.

If there are no capital gains in 2008, none of the $6,300 can be deducted, but it may all be carried over and used in later years through 2011. If there are no capital gains through 2011, the deduction is lost.

A corporation cannot carry capital losses back or forward to a year in which it was an S corporation (Code Sec. 1371(b)).

However, the years in which the entity is an S corporation are treated as tax years for purposes of determining the carryback and carryforward years.
Study Questions

1. A capital gain generally arises only on the sale or exchange of a capital asset.
   - True
   - False

2. All of the following are true regarding the "sale or exchange" requirement for capital gain treatment to apply except:
   - Generally, for income tax purposes, the terms "sale" and "exchange" have the same meanings as in everyday business transactions.
   - The term "sale" includes both a foreclosure sale and a voluntary surrender of property by the equity owner.
   - A redemption or retirement of bonds is not treated as a sale or exchange of property.

3. Bob Baxter, a farmer, removes and sells topsoil from his land. Which of the following best describes the tax treatment of the sale proceeds?
   - The proceeds from the sale are ordinary income.
   - The proceeds from the sale are capital gains.
   - The proceeds from the sale are long-term capital gains, provided Bob held the asset for more than one year.

4. If Susan Spencer had net long-term capital losses that exceeded the $3,000 capital loss limitation, which of the following best describes the tax treatment of her excess losses?
   - The unused portion may be carried over for five years as a long-term capital loss.
   - The unused portion may be carried over indefinitely as a short-term capital loss.
   - The unused portion may be carried over indefinitely as a long-term capital loss.

5. Dagny Corporation suffered $5,000 of capital losses in 2007. Dagny had no capital gains against which to offset its losses. Dagny may offset up to $3,000 of its ordinary income with its 2007 capital losses.
   - True
   - False

6. On June 1, 2007, Gina Grissom sold property that qualified for long-term capital gain treatment. Gina originally purchased the property in 1995. What is the lowest tax rate that could apply to this sale?
   - 8 percent
   - 5 percent
   - 15 percent
7. Rachel Richards inherited Coca-Cola stock from her aunt who died on January 2, 2007. If Rachel sells the stock on March 1, 2007, how will her gain, if any, be taxed?

- As short-term capital gain
- As ordinary income
- As long-term capital gain

8. Steve Sander's brother, Charlie, sells him stock for $7,600. Charlie's cost basis was $10,000. Later, Steve sells the same stock to an unrelated party for $6,900. Steve's recognized loss is:

- $0
- $700
- $3,100
Gains and Losses on Code Sec. 1231 Assets

Code Sec. 1231 Assets: Property That May Be Treated as Capital Assets

When a taxpayer disposes of business property, the resulting taxable gain or loss is usually a transaction to which Code Sec. 1231 applies.

Thus, the treatment of a gain or loss as ordinary or capital is determined under the rules for Code Sec. 1231 transactions.

Further, their treatment as ordinary or capital depends on whether the taxpayer has a net gain or a net loss from all Code Sec. 1231 transactions.

As listed previously in this course, the term "capital asset" does not include depreciable property or real estate used by the taxpayer in a trade or business (Code Sec. 1221(2)).

However, Code Sec. 1231 does grant assets of this type limited status as capital assets, giving rise to capital gains treatment, provided that gains from sales of such assets exceed losses.

If a taxpayer has a net Code Sec. 1231 gain, it is considered ordinary income up to the amount of the taxpayer's nonrecaptured Code Sec. 1231 losses from previous years.

The rest, if any, is long-term capital gain. If the taxpayer has a net Code Sec. 1231 loss, it is treated as an ordinary loss.

Certain calculations are necessary in order to determine the amount of net Code Sec. 1231 gains to be offset against capital losses. The items included in the Code Sec. 1231 category are:

- Depreciable property used in a trade or business
- Real property used in a trade or business and not held regularly for sale to customers
- Cut timber, when a taxpayer has elected to report gain at the time of cutting
- Coal, timber, and domestic iron ore royalties
- Unharvested crops sold with land if the land (but not necessarily the crops) has been held for the proper period
- Livestock (but not poultry) held for at least 24 months by a taxpayer for draft, breeding, dairy, or sporting purposes
- Compulsory or involuntary conversion of any of the property described in items above
- Compulsory or involuntary conversion of a capital asset held in connection with a trade or business or in a for-profit transaction

Except for livestock, the property described in the above list must be held for more than 12 months in order to qualify for capital gain treatment.

The first two items, depreciable and real property used in a trade or business, do not include: inventorable assets; property held primarily for sale to customers in the ordinary course of trade or business; copyright; literary, musical, or artistic composition; letter or memorandum; or U.S. government publications received by a taxpayer without charge or below the price at which they are sold to the general public (as described earlier in this course, in the section on Capital Assets Defined). Cut timber is elective.

For purposes of Code Sec. 1231, the term "trade or business" is not narrowly construed. Renting out a single residence has been held to be a trade or business.

In the case of a net gain, where the gains from Code Sec. 1231 transactions exceed the losses from such transactions, each gain is a long-term capital gain and each loss is a long-term capital loss.
If, on the other hand, there is a net loss, then each loss is an ordinary loss, and each gain is ordinary income.

A taxpayer may not include gains on some of the items and omit losses on other items in determining whether Code Sec. 1231 gains exceed Code Sec. 1231 losses.

**Example:** A taxpayer makes, during the tax year, the following sales of assets used in his trade or business and held for more than 12 months:

<table>
<thead>
<tr>
<th></th>
<th>Gains</th>
<th>Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Printing press</td>
<td>$5,000</td>
<td></td>
</tr>
<tr>
<td>Truck</td>
<td></td>
<td>$500</td>
</tr>
<tr>
<td>Warehouse</td>
<td></td>
<td>2,500</td>
</tr>
<tr>
<td>Unimproved lot used for parking trucks</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$6,000</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

Since the Code Sec. 1231 gains exceed the Code Sec. 1231 losses, each gain and each loss is treated as a long-term capital gain or long-term capital loss.

**Example:** Assume the same facts as in the previous example. Assume further that during the same tax year, the taxpayer sold investment property (Code Sec. 1221 capital assets) as follows:

<table>
<thead>
<tr>
<th></th>
<th>Gain</th>
<th>Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock (held 12 months or less)</td>
<td>$5,000</td>
<td></td>
</tr>
<tr>
<td>Bonds (held more than 12 months)</td>
<td>$7,000</td>
<td></td>
</tr>
</tbody>
</table>

Since the gains and losses in the first example are to be treated as capital gains and capital losses pursuant to Code Sec. 1231, they must be grouped with the capital gain and capital loss on the sale of the Code Sec. 1221 capital assets, as follows:

<table>
<thead>
<tr>
<th></th>
<th>Long-Term Capital Gains</th>
<th>Long-Term Capital Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Printing Press</td>
<td>$5,000</td>
<td></td>
</tr>
<tr>
<td>Unimproved Lot</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Bonds</td>
<td>7,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$13,000</td>
<td></td>
</tr>
<tr>
<td>Trucks</td>
<td>$500</td>
<td></td>
</tr>
<tr>
<td>Warehouse</td>
<td>2,500</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$3,000</td>
<td></td>
</tr>
</tbody>
</table>

Net long-term capital gain ($13,000 minus $3,000) is $10,000. Excess of net long-term capital gain over net short-term capital loss ($10,000 minus $5,000, the stock) is $5,000.
If Code Sec. 1231 gains exceed Code Sec. 1231 losses, each of the gains and losses must be grouped as 15 percent (5 percent if the taxpayer is in the 10 percent or 15 percent tax bracket until 2008 when the 5 percent rate is reduced to zero), 25 percent, and 28 percent.

Except for gain recaptured as ordinary income under Code Sec. 1250, gain to the extent of past depreciation on a building is characterized as "Section 1250 unrecognized gain," and taxed at a maximum 25 percent rate.

**Example:** Assume that a taxpayer sold a building on which $20,000 gain was recognized ($15,000 of which was Code Sec. 1250 unrecognized gain). In addition, the taxpayer sold unimproved land (held long-term) for a gain of $8,000.

The gain on the sale of the land and $5,000 of the gain on the sale of the building must be grouped together as being subject to the 15 percent rate. The balance of the gain on the sale of the building ($15,000) is a 25 percent gain.

**Example:** Assume that the taxpayer, an individual, has a $1,000 long-term capital gain on the sale of stock and a $3,000 Code Sec. 1231 loss on the sale of a business truck.

Because there is a capital gain and an ordinary loss, the two items are not grouped together.

Gains or losses on business properties not within the scope of either Code Sec. 1221 or 1231, such as depreciable property held for 12 months or less, generally produce ordinary gain or loss, and are governed by other provisions of the Code, such as Code Sec. 61 and Code Sec. 165.

### Involuntary Conversion

Gains and losses from an **involuntary conversion** (condemnation, destruction, or loss by theft or casualty) fall within the general rule of Code Sec. 1231, except where the taxpayer is required or elects not to have the gain recognized under Code Sec. 1033.

Code Sec. 1231 covers gains and losses from the involuntary conversion of depreciable business property. Code Sec. 1231 also applies to capital assets held for more than 12 months that the taxpayer used in a trade or business, or in a transaction entered into for profit.

However, a foreclosure or the imminence of one does not fall within the statutory definition of an involuntary conversion.

Therefore, the casualty or theft must have affected business property, property held for the production of rents and royalties, or investment property (such as notes and bonds). In addition, the taxpayer must have held the property longer than 12 months.

Gains and losses in this category must be netted separately from other Code Sec. 1231 transactions.

If there is a net gain, it is treated as a Code Sec. 1231 gain and combined with other Code Sec. 1231 gains and losses to see if there is a net Code Sec. 1231 gain or loss. (A gain on a casualty or theft loss occurs when an insurance recovery exceeds the adjusted basis of the property.)
If the netting of the casualty gains and losses results in a net loss, neither the gains nor the losses are taken into account in the section 1231 computation. Instead, the net loss is treated as an ordinary loss (Code Sec. 1231(a)(4)(C); Reg. 1.1231-1(e)(3)).

The net gain or loss that remains after separately netting the casualty gains and losses is to be treated under Code Sec. 1231 as a capital gain if a net gain is the result of this netting, and an ordinary loss if a net loss is the result (IRC §1231(a)(1) & (2); Reg. 1.1231-1(a)).

Gains and losses from personal casualties are not subject to the netting treatment of Code Sec. 1231.

Sale of Depreciable Property at a Gain

If the netting of Code Sec. 1231 gains and losses produces a net Code Sec. 1231 gain for the year, a five-year lookback rule applies, to recharacterize the current year's net Code Sec. 1231 gain as ordinary income to the extent of the net Code Sec. 1231 losses in the five-year lookback period that have not been previously recaptured as ordinary income under this rule.

Example: A calendar-year taxpayer has net Code Sec. 1231 losses of $11,000 and $3,000 in 2004 and 2005. He has a net Code Sec. 1231 gain of $5,000 in 2006 and a net Code Sec. 1231 gain of $30,000 in 2007. He had no gains or losses in 2003.

The taxpayer's nonrecaptured net Code Sec. 1231 loss is $9,000 ($11,000 + $3,000 - $5,000). As a result, $9,000 of the taxpayer's $30,000 net Code Sec. 1231 gain for 2007 is treated as ordinary income, and the remaining $21,000 is treated as long-term capital gain.

If the taxpayer has a net Code Sec. 1231 gain of $5,000 in 2008, the entire amount is treated as long-term capital gain since all of the net Code Sec. 1231 losses in the recapture period were recaptured in 2007.

If the taxpayer's Code Sec. 1231 gains consist of a combination of 15, 25, and 28 percent amounts, a special ordering procedure is used (Notice 97-59, I.R.B. 1997-45).

Prior year's net Code Sec. 1231 losses are first recaptured from current year 28 percent gains, then 25 percent gains, and finally 15 percent gains.

Gain on the sale or other disposition of Code Sec. 1245 property is taxable as ordinary income to the extent of previous depreciation deductions.

Such property is defined as any personal property that is or has been of such a character as to be subject to depreciation under Code Sec. 167 and certain other property.

Gain on the sale, exchange, or other disposition of depreciable realty (Code Sec. 1250 property) may be taxable as ordinary income to the extent of the depreciation deductions taken on the property in excess of what straight-line depreciation would have been.

Gain on the sale or other disposition of recovery property that is Code Sec. 1250 property is taxed as ordinary income to the extent of statutory ACRS allowances over straight-line ACRS allowances.

Recapture on the disposition of post-1986 residential rental property and nonresidential real property is not required since these properties are depreciated under the straight-line method.
However, as discussed above, a maximum capital gains rate of 25 percent applies to unrecaptured Code Sec. 1250 gains.

Study Questions

1. Under Code Sec. 1231, gains and losses resulting from the sale of depreciable property or real estate used in a taxpayer’s trade or business are always treated as though they were gains and losses from the sale of capital assets held for more than 12 months.
   - True
   - False

2. Samuel Johnson’s net Code Sec. 1231 gains and losses since 2002 are as follows:
   
   2002—$50,000 loss
   2003—$15,000 loss
   2004—$20,000 loss
   2005—$10,000 loss
   2006—$40,000 gain
   2007—$50,000 gain

   How much of Samuel’s 2007 net Code Sec. 1231 gain will be recaptured as ordinary income?
   - $0
   - $45,000
   - $50,000
3. Sam Jones has the following casualty gains and losses in 2007:

   Gain on the destruction by fire of hardware store—$10,000
   Loss on destruction by hurricane of residential rental property—$15,000 and
   Loss on theft of diamonds purchased for personal use—$5,000

All of the assets were held for more than one year. Sam should report:

- $10,000 net Code Sec. 1231 loss
- $10,000 ordinary loss
- $5,000 ordinary loss and $5,000 itemized deduction

4. All of the following are considered Code Sec. 1231 transactions except:

   - Sale of depreciable property used in a trade or business, if held longer than one year.
   - Sale of real property used in a trade or business, if held longer than one year.
   - Gains and losses from condemnations, thefts and casualties affecting business property, if the property was held longer than one year.
   - Sale or exchange of property held mainly for sale to customers.
Recapture of Deductions

Recapture on Disposition of Property

If a taxpayer disposes of depreciable or amortizable property at a gain, the taxpayer may have to treat all or part of the gain (even if otherwise nontaxable) as ordinary income.

A gain on the sale or other disposition of property used in a trade or business or held for investment (Code Sec. 1245 property) is taxed as ordinary income to the extent of depreciation deductions claimed, including any reduction in basis due to an election to expense under Code Sec. 179 or to take the investment tax credit.

Once property is classified as Code Sec. 1245 property, it can never lose its character as such in the hands of the taxpayer.

Code Sec. 1245 property includes:

- All personal property, whether tangible or intangible
- Other tangible property, not including a building or its structural components, used in manufacturing, production, extraction, furnishing transportation, communications, electrical energy, gas, water or sewage disposal services, or a research or storage facility used in connection with the above activities
- Real property, to the extent that its adjusted basis reflects adjustments for amortization
- A single purpose agricultural or horticultural structure
- A storage facility, not including a building or its structural components, used in connection with the distribution of petroleum or any primary product of petroleum
- Any railroad grading or tunnel bore (Code §1245(a)(3))

Nonresidential buildings placed in service after 1980 and before 1987, on which ACRS depreciation was taken, are also treated as Code Sec. 1245 assets.

The amount that must be recaptured as ordinary income is the lesser of either the total depreciation, cost recovery, or amortization deductions allowed or allowable with respect to the property, or the total gain realized (Code Sec. 1245(a)(1)).

If the total of the depreciation, cost recovery, and other amortization deductions is greater than the gain realized, only the actual amount of the gain realized needs to be reported.

However, the entire amount of the gain is ordinary income.

Depreciation Recapture on the Sale of Personal Property

Generally, any gain on the sale or other disposition of tangible personal property is taxable as ordinary income to the extent of depreciation deducted (or deductible).

For purposes of this rule, any deduction allowed under the expensing provisions of Code Sec. 179 is deemed a depreciation deduction.

The depreciation recapture may not be greater than the gain in the case of a sale, exchange, or involuntary conversion.

For other dispositions, the recapture may not be more than the excess of the fair market value of the property over its adjusted basis.
Although property may not be depreciable in the taxpayer's hands, it will still be Code Sec. 1245 property if it was depreciable by a prior holder and the depreciation deductions by that holder were taken into account in determining the adjusted basis to the taxpayer.

Dispositions of Code Sec. 179 property will be discussed in further detail later in this course.

**Depreciation Recapture for 'Listed' Property**

Depreciation recapture may be needed for listed property that is not actually disposed of.

This depreciation recapture applies when the business usage of a car or other listed property falls to **50 percent or less**.

**Gain from Dispositions of Certain Depreciable Property**

Under Code Sec. 1250, part or all of a gain realized on the sale or other disposition of a building that has been used in a trade or business, or held for investment, may be taxed (recaptured) as ordinary income.

The amount that may be recaptured depends on the use of the building when it was acquired and on the depreciation method used (Code Sec. 1250).

**Code Sec. 1250 Property**

Code Sec. 1250 property is property that is depreciable under Code Sec. 167 but is not subject to the recapture rule under Code Sec. 1245.

This property includes **all intangible real property** (such as leases of land or Code Sec. 1250 property, buildings, and their structural components) and all other **tangible real property except** property that is used as an integral part of manufacturing, production, or extraction; or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services; or research or storage facilities used in connection with these activities.

Even though Code Sec. 1250 property may not be subject to depreciation in the current taxpayer's hands, it is still classified as Code Sec. 1250 property **if depreciation was taken** by a prior owner and this depreciation was taken into consideration in determining the adjusted basis of the property in the hands of the present owner.

The following general rules apply to buildings other than those involving rental housing and those that have been depreciated by using a post-1980 cost recovery system:

- If the depreciable realty is held for 12 months or less, all depreciation claimed regarding the property (not just the excess over straight-line) is recaptured as ordinary income to the extent of the gain.
- If the depreciable realty is held over 12 months, only additional depreciation claimed regarding the property (the excess over straight-line) is recaptured as ordinary income to the extent of the gain.

**Additional depreciation** is defined as depreciation deductions taken by the taxpayer after 1963 in excess of straight-line depreciation.

For property held for one year or less before its disposition, a special rule provides that additional depreciation is the depreciation taken on the property (Code Sec. 1250(b)(1)).
Recapture on the disposition of residential rental property and nonresidential real property placed in service after 1986 is not required since such property must be depreciated under the straight-line MACRS method.

Where substantially improved Code Sec. 1250 property is disposed of, special rules apply for determining the amount of ordinary income to be recognized on each "separate improvement."

To be considered a "separate improvement," the cost of the improvements during a three-year period must exceed the greatest of:

- 25 percent of the adjusted basis of the property
- 10 percent of the original cost of the property plus the cost of any improvements made before those being considered, less the cost of retired components
- $5,000

Unrecaptured gains. The portion of the long-term capital gain that, on the sale of depreciable realty, would have been recaptured as ordinary income if the property was subject to the provisions of Code Sec. 1245 is referred to as "unrecaptured Code Sec. 1250 gain."

This type of gain is taxed at a maximum rate of 25 percent. The balance of the long-term capital gain is taxed at a maximum rate of 15 percent.

Example: An individual sold an office building on July 14, 2007 for $1.2 million. His adjusted basis in the building was $200,000. The building originally cost $600,000 and has been depreciated using the straight-line method.

Of the taxpayer's $1 million gain, $400,000 ($600,000 - $200,000) is unrecaptured Code Sec. 1250 gain that is taxed at 25 percent.

The balance of the gain, $600,000 ($1,000,000 - $400,000) is taxed at 15 percent.

Special Recapture Rules on Sale of Residential Housing

For sales and exchanges of residential rental housing (other than governmentally subsidized and low-income rental units) in tax years beginning after 1975, all post-1975 depreciation that is in excess of straight-line depreciation is recaptured as ordinary income.

For tax years ending after 1975, the amount of recapture is governed by the following rules:

- Post-1975 excess depreciation will be 100 percent recaptured first. If this recapture is equal to or more than the gain on the sale, the gain will be all ordinary income, and no further computation is necessary.
- Excess depreciation that is attributable to the years after 1969 and before 1976 may be partially recaptured or fully recaptured if the post-1975 recapture under the previous rule is less than the gain. The amount of this recapture will be a percentage of either the 1970-1975 excess depreciation or the unrecaptured gain (gain less recapture under the first rule, whichever is less). This percentage is 100 percent for housing held for more than 12 months and less than 101 months. The percentage decreases by one percent for each month that the property has been held over 100 months, and there is no recapture under this rule after 16 2/3 years.

There is no recapture of 1963-1970 depreciation.
If the cost of pre-1987 residential rental real recovery property is recovered under a statutorily accelerated method of ACRS, gain on disposition is recaptured as ordinary income to the extent that ACRS deductions exceed the recovery that would have been allowed if the straight-line ACRS method had been used over the recovery period applicable to such property.

There is no recapture if the straight-line ACRS method is elected.

Dispositions of Code Sec. 179 Property

A Code Sec. 179 expense deduction is treated as a depreciation deduction for purposes of recapture.

Therefore, any gain recognized on disposition of Code Sec. 179 property is treated as ordinary income to the extent of amounts expensed and depreciation deducted.

Study Questions

1. The recapture rules in Code Sec. 1250 must be considered on the disposition of personal property that has been depreciated in earlier tax years.
   - True
   - False

2. Regarding Code Sec. 1245, which of the following is not a true statement?
   - Patents, copyrights and subscription lists are not section 1245 property.
   - Gain on the sale or other disposition of tangible personal property is taxable as ordinary income to the extent of depreciation deducted.
   - If a father makes a gift to his son of an automobile previously used 100 percent in the father's business, and the son thereafter uses the car solely for personal purposes, the car is section 1245 property in the son's hands.

3. Carolyn Davis sold an office building on July 10, 2007 that was depreciable under Code Sec. 167. She had owned the building for 10 years and used the straight-line method of depreciation. To the extent that Carolyn has unrecaptured Code. Sec. 1250 gain, it will be:
   - Taxed at a maximum rate of 15 percent
   - Taxed at a maximum rate of 25 percent
   - Taxed as ordinary income at the taxpayer's highest marginal rate
4. In 2005, Dave Davis claimed a Code Sec. 179 expense deduction of $15,000 for qualifying business assets used in his construction business. He also claimed $10,000 in depreciation deductions for those same assets before selling them in December 2007. If Dave disposes of these assets at a gain, he will have to recapture as ordinary income:

- $10,000
- $15,000
- $25,000
Special Rules

Options to Buy or Sell

An option is a contract under the terms of which the grantor (writer or seller of the option), in exchange for consideration (premium), undertakes an obligation to purchase from or to sell to the other party to the contract (holder or optionee or buyer), a specific property at an agreed-on price (exercise or strike price).

Gain or loss from the sale or exchange of an option, including a cash settlement option, is considered a gain or loss arising from property that has the same character as the property underlying the option.

A capital gain or loss occurs only when the option covers property that is a capital asset or would be a capital asset if acquired by the taxpayer (Code Sec. 1234; Reg. §1.1234-1).

If the option is exercised, the holding period of the option does not carry over to the property acquired.

The holding period for the property begins on the day after the property is obtained.

Losses attributable to the failure to exercise an option to buy or sell property are capital losses if the property covered by the option is a capital asset or would be a capital asset if it were acquired by the taxpayer.

A loss is not deductible if the taxpayer paid nothing for the option or did not realize taxable income on receipt of the option, warrant, or right.

Further, a taxpayer may not deduct a loss if the option was acquired in a purely personal transaction that was not connected with a trade or business or profit-motivated transaction.

Gains or losses from closing transactions with respect to options must be treated as short-term capital gains or losses.

A closing transaction is the termination of a grantor's obligation under an option to buy a call or sell a put other than through the exercise or lapse of an option.

In effect, this rule discourages investors from structuring their investment positions according to the tax benefits that would result.

The above-mentioned rules do not apply in the case of options written by taxpayers in the ordinary course of their trade or business.

Gains and losses from option transactions in the ordinary course of a trade or business (i.e., for "dealers") will be treated as ordinary gains or losses.

Dealers in Securities

Capital gain classification is available to securities dealers on securities held for investment purposes, if these securities are clearly identified in the dealers' records as investment securities before the close of business on the day on which they are acquired (Code Sec. 1236(a)).

Further, if an investment is acquired by exercise of an option, the option must be identified as such by the close of the business day on which it is acquired in order for the securities received through the option to be eligible for capital gain treatment (Code Sec. 1236(e)).
In any event, the securities must not at any time thereafter be held by the dealer primarily for sale to customers in the ordinary course of business, although the nominee in whose name the securities are held may be the nominee of the securities dealer.

**Losses** from the sale of investment securities are also capital losses where the security sold is clearly identified in the dealer's records as a security held for investment (Code Sec. 1236(b)).

### Sales of Stock in Small Businesses

**Exclusion for Gain from Small Business Stock**

To encourage investment in new ventures and small businesses, Code Sec. 1202 grants offer relief to investors who risk their funds in these businesses.

Noncorporate investors may exclude up to 50 percent of the gain they realize on the disposition of qualified small business stock issued after August 10, 1993, and held for more than five years (Code Sec. 1202(a)).

The amount of gain eligible for the 50 percent exclusion is subject to per-issuer limits. The exclusion is available to taxpayers who own eligible stock in a qualified corporation that actively conducts a qualified trade or business and meets a maximum gross assets test.

**Loss on Section 1244 Stock**

An individual may take a limited ordinary loss deduction for loss sustained on the sale, exchange, or worthlessness of small business stock ("Section 1244 stock").

To qualify as Section 1244 stock, the stock must be issued for money or property (other than stock or securities) in a domestic small business corporation. During its five most recent tax years before the loss, the corporation must have derived more than 50 percent of its gross receipts from other than rents, royalties, dividends, interest, annuities and gains from sales and exchanges of stocks or securities.

In addition, the corporation must have been an operating company in order for the ordinary loss rules to apply.

### Sales of Real Property

Sometimes the distinction between a person who is a real estate dealer and one who is merely an investor is a fine one.

**Real estate** used in a trade or business, including rental property, is subject to Code Sec. 1231 treatment.

It is grouped with the other types of assets covered by Code Sec. 1231, and, if there is an overall loss, the loss is deductible in full as an **ordinary loss**. If there is an overall gain, it is a **capital gain**.

However, part or all of the gain on the sale of depreciable real property may be recaptured as ordinary income under Code Sec. 1250.

If the property is held for sale to customers in the ordinary course of the taxpayer's business, it is neither a capital asset in its own right nor property treated as such under Code Sec. 1231.

All the gain from its sale is ordinary income and any loss is an ordinary business loss, deductible in full against any income.
Sale of Principal Residence

Under Code Sec. 121, homeowners who own and live in their homes for at least two out of the five years preceding the date of sale can exclude up to $250,000 ($500,000 on a joint return) of the gain realized on the sale or exchange of a principal residence. In order to qualify for this exclusion, the taxpayer must satisfy both ownership and use tests.

Further, the exclusion cannot be used more frequently than once every two years. An individual who fails to meet the ownership and use requirements, or the minimum two-year time period for claiming the full exclusion, may still be eligible for a partial exclusion when the sale is due to either a change in place of employment, health reasons, or unforeseen circumstances.

Some homeowners may be adversely affected by new rules that close an apparent loophole by limiting the exclusion available for gain realized on the sale of a principal residence.

The American Jobs Creation Act of 2004 (AJCA) provides that the exclusion from gain described above is not allowed if the principal residence was acquired in a like-kind exchange within the prior five years and any gain on such exchange was not recognized.

Thus, when an individual acquires a principal residence in a like-kind exchange, the new law requires that the individual own the property for at least five years prior to its sale or exchange in order for the exclusion of gain rule to apply (Code Sec. 121(d)(10)).

Real Estate Dealer

An active real estate dealer can also hold investment real estate for himself. In each case it is essentially a question of fact whether the property is investment property, and therefore a capital asset, or whether it is held primarily for sale to customers in the ordinary course of the dealer's trade or business.

Both the U.S. Court of Appeals for the Third Circuit and the Tax Court have held that the taxpayer's motivation in holding a property is controlling.

For the purpose of determining whether a property is held primarily for sale in the ordinary course of a trade or business, the courts have developed a number of tests, such as:

- The purpose or reason for the taxpayer's acquisition of the property, as well as the reason for the disposition of it
- The continuity of sales or sales-related activity over a period of time and the number and frequency of sales
- The extent to which the taxpayer or the taxpayer's agents engaged in sales activities by developing or improving the property, soliciting customers, or advertising, as well as the substantiality of sales when compared to other sources of the taxpayer's income
- The desire to liquidate unexpectedly obtained land holdings (such as those obtained by inheritance)
- Overall reluctance to sell the property
- The length of time that the property was held and the substantiality of the gain realized on the sale

However, reliance on such factors can be deceptive since they focus more on marketing techniques than on the taxpayer's motivation in holding the property.
Subdivider

A noncorporate taxpayer (or S corporation, for tax years beginning after December 31, 1997) will not be treated as a real estate dealer merely because real estate acquired as an investment or for use in a trade or business is later subdivided and sold in lots.

Although the sale of these lots may resemble sales of property in the ordinary course of a trade or business, the sale of the subdivided realty will not automatically all be considered ordinary income (Code Sec. 1237).

Three requirements must be met before Code Sec. 1237 applies:

- The tract or any lot or parcel in it was never previously held by the taxpayer primarily for sale to customers in the ordinary course of business, and, in the same tax year in which the sale occurs, the taxpayer does not so hold any other real property. (This rule automatically excludes real estate dealers.)
- No substantial improvement, other than some "necessary" improvements, is made on the tract by the taxpayer, or is made under a contract between the taxpayer and the buyer.
- The lot or parcel is held by the taxpayer for a period of at least five years unless it was acquired by inheritance or devise; in the latter event, the taxpayer must hold the land for more than one year in order to receive long-term capital gain treatment (Code Sec. 1237(a)).

If not more than five lots have been sold or exchanged by the end of any tax year, the entire profit is capital gain.

In the tax year in which the sixth parcel is sold, and in all later tax years, gains from all sales of the lots or parcels are treated as ordinary income to the extent of 5 percent of the selling price. The remainder is capital gain.

Accordingly, if a subdivider sells or exchanges six lots or more in one tax year, the gain on all sales or exchanges is taxed as ordinary income to the extent of 5 percent of the selling price.

Expenses of sale first offset the 5 percent that is treated as ordinary income.

Any excess is offset against the selling price to determine the amount of capital gain (Code Sec. 1237(b)(2)).

Subdivision Tract

The special rules for determining whether real estate is held for sale in the ordinary course of business apply to each single subdivision tract.

A tract is a single piece of real property, except that two or more pieces of real property will be considered a single tract if at any time they were contiguous in the hands of the taxpayer, or if they would be contiguous except for a road, street, railroad, stream, or similar property.

If, after the sale or exchange of any lot or parcel from a tract, no further sales or exchanges from the tract are made for a period of five years, the remainder is a new tract, and the sales sequence can start all over.

That is, the taxpayer may count the sales of the first five lots again before the special 5 percent rule comes into operation (Code Sec. 1237(c)).
Sales of Depreciable Property to Certain Related Persons

The gain from sales or exchanges of depreciable property is treated as ordinary income, rather than capital gain, where the sale or exchange is made, directly or indirectly, between:

- A person and either a partnership or a corporation in which the person, either directly or indirectly, owns more than 50 percent of the outstanding stock or profits interest
- A taxpayer and a trust or an estate in which the taxpayer (or spouse) has a beneficial interest other than a remote contingent interest
- An employer and any person related to the employer under the first and second requirements
- A welfare benefit fund that is controlled directly or indirectly by persons referred to in the third requirement (Code Sec. 1239(a); Code Sec. 1239(b))

Currently, no gain or loss is generally recognized on transfers of property between spouses. Sales to a taxpayer's children, parents, brothers, or sisters are not proscribed by Code Sec. 1239.

Ownership of 50 percent or more of a corporation's stock is measured by the value of the outstanding stock, and ownership of 50 percent or more of a partnership is measured by interests in capital or profits directly or indirectly owned by a person.

For purposes of this related-person provision, attribution applies between spouses and among corporations (Code Sec. 1239(c)).

**Example:** Sam Smith owns 50 percent of the outstanding stock in X Company. Another 30 percent of the stock is owned by a trust for his wife.

Because his wife is deemed to own the stock that is owned for her benefit by the trust, Sam Smith, in turn, constructively owns the stock.

Thus, Sam Smith is deemed to own 80 percent of the stock in X Company and any gain recognized from the sale of depreciable property between the company and the trust would be treated as ordinary income.

**Example:** James Jones owns 80 percent of the stock of A and B Companies.

He attempts to avoid the application of the rule of Code Sec. 1239 by contributing his stock in B Company to a newly formed holding company, C Company, in which he owns all of the stock.

After this transfer, he has A Company sell depreciable property to B Company.

Under the attribution rules, James Jones is treated as owning the B Company stock owned by C Company. Thus, his gain from the sale is treated as ordinary income.

Depreciation recapture rules under Code Secs. 1245 and 1250, as previously explained, may cause all or part of the gain on any depreciable property to be treated as ordinary income.
If the transaction is a sale or an exchange between related interests, gain not recaptured under either of the aforementioned statutes may be treated as ordinary income under Code Sec. 1239.

Study Questions

1. A real estate dealer who holds property as part of his stock-in-trade is not subject to capital gains treatment of gains and losses on the sale of the property.
   - True
   - False

2. Under Code Sec. 1237, if a taxpayer has made substantial improvements to a lot or parcel of land, gains on the sale of subdivided tracts will be deemed:
   - Capital gains
   - Ordinary income
   - Section 1245 gain

3. Code Sec. 1237 applies to:
   - Dealers in securities
   - Gain from the sale of depreciable property between related taxpayers
   - The subdivisions and sale of real estate

4. On January 1, 2007, Lisa Rand purchased an option to acquire certain investment real estate before April 1, 2008. On March 1, 2008, Lisa exercises the option and obtains the property. If Lisa later sells the property, in order to determine whether any gain (or loss) would be classified as short-term or long-term, Lisa's holding period for this property begins on:
   - January 1, 2007
   - March 2, 2008
   - March 1, 2008
Final Exam

Exam Instructions: Choose the best answer for each question below based upon the information provided in the course content. Then submit your answers.

You can change your answers any time prior to clicking the submit test button.

You have three (3) chances to submit the exam for a passing grade. Each time you click the Submit button is considered an attempt.

Users of JAWS accessibility software may use the "P" key to navigate the screens containing Study Questions or the Final Exam.

Expiration: This course must be completed within one year of enrollment.

1. Under the Jobs and Growth Tax Relief Reconciliation Act of 2003:
   - The maximum capital gains rate for corporations is 15 percent.
   - Capital assets that the taxpayer owns for at least five years are eligible for a special rate reduction.
   - The maximum rate of tax on capital gains for individuals is 15 percent.
   - After December 31, 2007, the lower rates on long-term capital gains expired.

2. Rob Seymour owns 50 percent of the outstanding stock in X company. Another 30 percent of the stock is owned by a trust for Rob’s wife. Any gain recognized from the sale of depreciable property between the company and the trust would be treated as:
   - Ordinary income
   - Short-term capital gain
   - Long-term capital gain
   - Part non-taxable and part long-term capital gain

3. “Unrecaptured Code Sec. 1250 gain” refers to the portion of long-term capital gain that, on the sale of depreciable realty, would have been recaptured as ordinary income if the property was subject to the provisions of Code Sec.1245.
   - True
   - False

4. Code Sec. 1231 assets include depreciable property used in a taxpayer’s trade or business.
   - True
   - False
5. A calendar-year taxpayer had net Code Sec. 1231 losses of $8,000 in 2005. He had net Code Sec. 1231 gains of $5,250 and $4,600 in 2006 and 2007, respectively. There were no net Code Sec. 1231 losses in 2002, 2003, or 2004. What portion of the net Code Sec. 1231 gain is reported as ordinary income, and what portion is considered long-term capital gain in 2007?

- $5,250 is reported as ordinary income and no portion is treated as long-term gain.
- No long-term capital gain is reported and $3,400 is reported as ordinary income.
- $2,750 is reported as ordinary income and $1,850 is reported as long-term capital gain.
- $2,150 is reported as long-term capital gain and $2,400 is reported as ordinary income.

6. On June 7, 2007, Roland Rye purchased a $500 option from Sandra Suisse to purchase certain investment real estate prior to April 1, 2008. Roland Rye does not exercise the option; he lets it expire. Roland Rye will treat the $500 as:

- A short-term capital gain
- A short-term capital loss
- A long-term capital gain
- A long-term capital loss

7. Edward Point owns 50 percent of the outstanding stock in C Company. Another 30 percent of the stock is owned by a trust in which Edward’s wife is the sole beneficiary. Edward sells a depreciable business asset to the trust. The gain or loss from the sale is treated as:

- Capital gain or loss
- Ordinary gain or loss
- Part capital gain or loss and part ordinary gain or loss
- None of the above
8. Bill Baxter is in the process of selling his hardware store, which he operates as a sole proprietorship. Bill has provided the following information:

- Accounts receivable: $40,000
- Inventories: 60,000
- Buildings: 80,000
- Copyrights: 40,000
- Goodwill: 60,000
- Land: 80,000
- Furniture and fixtures: 40,000

What is the value of Bill's capital assets?
- $60,000
- $100,000
- $120,000
- $160,000
- $300,000

9. Mike Nichols had the following capital transactions during the current tax year:

<table>
<thead>
<tr>
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<th>Short-term</th>
<th>Long-term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gains</td>
<td>$6,000</td>
<td>$23,000</td>
</tr>
<tr>
<td>Losses</td>
<td>9,000</td>
<td>10,000</td>
</tr>
</tbody>
</table>

What portion of Mike's capital gains is included in his adjusted gross income?
- $2,000
- $3,000
- $4,000
- $5,000
- $10,000
10. In 2007, Greg Johnson had taxable income of $100,000. This amount included short-term capital losses of $1,000 and long-term capital losses of $12,000. He had no other capital transactions in prior years. What is Greg’s capital loss carryover to 2008?

- $5,000
- $7,000
- $8,000
- $10,000
- $13,000

11. Dealers in securities are allowed capital gain classifications for certain types of stock. To which of the following securities does this apply?

(1) Securities held primarily for sale to customers

(2) Securities held for investment purposes if clearly identified as such before the end of business on the day acquired

(3) Securities acquired through the exercise of an option only if clearly identified as being held for investment by the close of the business on the day acquired

- (1) only
- (3) only
- (1) and (2)
- (1) and (3)
- (2) and (3)

12. In 2007, a corporation had a net long-term capital gain of $130,000 and a net short-term capital loss of $150,000. What is the corporation’s loss, and what is the first year to which it may be taken to offset available capital gain?

- $10,000 long-term capital loss carried back to 2004
- $20,000 short-term capital loss carried back to 2004
- $15,000 short-term capital loss carried back to 2004
- $20,000 long-term capital loss carried back to 2004
13. Capital gains and losses generally do not result unless there is a sale or exchange. An exception to this rule occurs when an investor holds corporate stock that becomes worthless.

- True
- False

14. If a taxpayer had elected to expense, under Code Sec. 179, all or part of qualifying depreciable business assets and the assets are disposed of in a later tax year, any gain recognized is treated as ordinary income to the extent of:

- The amount expensed, plus depreciation deducted
- Depreciation deducted only
- Depreciation deducted over straight-line rate only
- The amount expensed under Code Sec. 179 only

15. Real estate used in a trade or business is a capital asset, but if it is held for investment, it is a Code Sec. 1231 asset.

- True
- False

16. Ricardo and Pilar Santana are husband and wife. Ricardo owns stock having a cost basis of $8,000. He transfers the stock to Margot Jones for $6,000, and Margot resells the stock at the same price to Pilar, all under a prearranged plan. May Ricardo deduct any of his loss?

- Yes, he may deduct the entire loss.
- No, he may not deduct any of the loss.
- He may deduct part of the loss.
- None of the above.

17. Code Sec. 1239 addresses:

- Loss from worthless securities
- Combining capital gains and losses
- Sales of depreciable property to related persons
- Holding periods
18. International Corporation sells equipment used in its business at a loss of $30,000. The equipment had been purchased 17 months earlier. The $30,000 loss is treated as:

- A capital loss
- A Code Sec. 1245 loss
- A Code Sec. 1231 loss
- A casualty loss

19. Code Sec. 1245:

- Applies to losses
- Does not apply to losses
- Applies to both gains and losses
- None of the above

20. An active real estate dealer:

- Will always be deemed to hold real property primarily for sale to customers in the ordinary course of business
- Will always be deemed to hold real property for investment purposes
- Will never be deemed to hold real property for investment purposes
- None of the above