¶ 31.01 Introduction

One of the principal complicating features of the federal income tax structure is the network of rules governing capital gains and losses. Except for a brief period in the late 1980s, since 1921 capital gains have been taxed more leniently than ordinary income, and the deductibility of capital losses has been subject to special limitations since 1924. [1] These principles have been controversial throughout their history, and the statutory details, which have varied widely from time to time, are the product of compromises among strongly held economic and political views, rather than the logical outgrowth of basic premises. From this maelstrom of contending theories, the following main features of current law have emerged:

1. A preferential rate of tax on "long-term" capital gains substantially below the marginal tax rate that applies to ordinary income.
2. Limits on the deduction of capital losses that permit capital losses of individuals and other noncorporate taxpayers to be deducted only against capital gains, plus a maximum of $3,000 of ordinary income. [2]
3. The carryover of unused capital losses forward indefinitely until used. [3]

The preferential treatment of capital gains is implemented by **§ 1(h)**, which provides an alternative tax formula that applies to determine the taxpayer's maximum income tax liability if he has "net capital gain" for the year, defined as net long-term capital gains in excess of net short-term capital losses. Generally speaking, most long-term capital gains realized by individual taxpayers that otherwise would be subject to the 10 and 15 percent rate brackets are taxed at a zero rate, long-term capital gains that otherwise would be subject to the marginal rates from 25 to 35 percent are taxed at 15 percent, and long-term capital gains that otherwise would be subject to the top rate of 39.6 percent are taxed at 20 percent. However, a number of special rules apply slightly lower and slightly higher preferential rates to capital gains recognized with respect to certain types of property. [4]

The restricted deductibility of capital losses sometimes has been rationalized as a quid pro quo reflecting the preferential rate applicable to capital gains. But it also rests on an independent rationale; viz., the facts that taxpayers holding depreciated property often have a relatively free hand in timing the realization of their losses, and that losses can sometimes be neutralized as an economic matter by purchasing similar property with the funds obtained by selling the loss property. Indeed, investors selling depreciated securities can ordinarily deduct their losses even though they repurchase identical securities, provided they avoid the so-called wash sale restriction of **§ 1091 of the Internal Revenue Code** (the Code). [5]

The mechanics of the capital loss restriction provide a second, though less dramatic, advantage that capital gains, even short-term capital gains not entitled to the benefit of the preferential rates, enjoy over ordinary income. This benefit is the amalgamation of capital gains with capital losses before the capital loss restriction takes effect, which can be illustrated as follows. Assume that a taxpayer's only relevant transactions in a given year are (1) a capital loss of $100,000; (2) a profit of $80,000 on a transaction that, depending on how it is classified, generated either ordinary income or capital gain; and (3) a salary of $75,000. As indicated by the example in Table 31-1, the taxpayer's income is $152,000 or $72,000, depending on whether the $80,000 profit is treated as ordinary income or as capital gain.

Table 31-1

Effect of Distinction Between Ordinary Income and Capital Gain on Treatment

of Capital Loss

		$80,000 profit classified as:	
		Ordinary income	*Capital gain*
1.	Salary	$ 75,000	$ 75,000
2.	Profit	80,000	80,000
		--------	--------
3.	Subtotal	$155,000	$155,000
4.	Less: Capital loss (limited to capital gain plus $3,000 of ordinary income)	3,000	83,000
		--------	--------
5.	Net income	$152,000	$ 72,000
6.	Capital loss carryforward ($100,000 minus line 4)	$ 97,000	$ 17,000

The preferential rate for long-term capital gains and the restricted deductibility of capital losses necessarily presuppose a method of separating capital gains and losses from ordinary income and losses. [6] The boundary between these concepts cannot be found in the world of business and industry but is instead established by the Code, as interpreted by the courts and the Internal Revenue Service (IRS). The principal landmarks are created by **§ 1222**, which refers to gains and losses "from the sale or exchange of a capital asset," and **§ 1221**, which defines the term "capital asset." From these provisions it is clear enough that listed securities held by an investor give rise to capital gain or loss when sold and, conversely, that a mercantile or manufacturing company realizes ordinary income or loss on selling its products. But between these polar extremes lie numerous categories of assets whose classification, which depends on the activities of the taxpayer who owns the property as well as the nature of the property itself, is often more difficult. Moreover, by requiring that a capital asset be disposed of in a "sale or exchange" for the gain or loss to be treated as a capital gain or loss, **§ 1222** creates interpretative problems when an asset is transferred pursuant to a foreclosure, corporate liquidation, or other unusual event.

The assignment of gains and losses to the "capital" or "ordinary" side of the boundary line is sometimes simplified, and in other instances complicated, by a series of statutory qualifications to the general pattern established by **§§ 1221** and **1222**. Under these ancillary rules, capital gain or loss treatment is accorded to gain or loss on the disposition of many items that do not constitute "capital assets" within the meaning of **§ 1221** or that are disposed of in transactions not constituting a "sale or exchange" under **§ 1222**. Thus, profit on the sale of business real estate, machinery, and equipment, as well as many intangible assets used in a trade or business may be treated as capital gain pursuant to **§ 1231** even though the property is not a capital asset under **§ 1221(a)(2)**, and investors are allowed to report certain patent royalties as capital gain even though the payments are received under a license that does not constitute a "sale or exchange" so far as **§ 1222** is concerned. Transactions like these may be brought within the shelter of the capital gain provisions because they closely resemble capital gain transactions or simply because Congress was persuaded, for extraneous reasons, that liberalized tax treatment was appropriate.

On the other hand, some transactions that meet the "capital asset" and "sale or exchange" standards of **§§ 1221** and **1222**, respectively, are nevertheless removed by statute from the capital gain and loss side of the dividing line, and give rise instead to ordinary income or ordinary loss. If, for example, a taxpayer sells a capital asset to a corporation in which he owns more than 50 percent of the stock, and the corporation holds the asset as depreciable property, any gain is taxed as ordinary income, even though the transaction would generate capital gain if the purchaser were unrelated. [7]

Although governed by an elaborate web of statutory provisions, capital gains and losses do not occupy a tax world of their own. The term "gross income," for example, includes both capital gains and ordinary income, so that provisions that refer to a dollar amount of gross income (e.g., **§ 6012(a)**, relating to the filing of tax returns) apply whether the income is ordinary or capital. There are many other statutory, administrative, and judicial rules that apply equally to capital and ordinary transactions in determining the amount of gain or loss, the time when gains and losses are taken into account, the deductibility of losses, and the recognition of gains and losses. Thus, the sale of a personal residence for less than its cost would produce a capital loss so far as **§§ 1221** and **1222** are concerned, but the homeowner will find that this is useless information since the loss, not having occurred in a trade or business or a transaction entered into for profit, cannot be deducted under **§ 165**. Because the actual tax treatment of transactions creating capital gains and losses always depends on provisions of more general import, it is essential that they be viewed in this larger context.

[1] From 1991 through 1997, the maximum rate of tax on long-term capital gains was 28 percent, which provided a benefit only to those individual and other noncorporate taxpayers whose ordinary income was subject to tax at a higher marginal rate. From 1988 through 1990, capital gains enjoyed no preference. For many years prior to 1987, the capital gain preference was a deduction of percentage of net capital gain (60 percent in the late 1970s and early 1980s, 50 percent before that). Prior to that, the capital gain preference was either a deduction equal to 50 percent of net capital gain or a maximum rate of 25 percent, whichever was more advantageous to the taxpayer. Prior to that, varying percentages of capital gain were excluded depending on how long the taxpayer had held the property; the exclusion ranged from 20 percent to 70 percent. Likewise, capital loss limitations have varied.

[2] **IRC § 1211**.

[3] **IRC § 1212**.

[4] For capital assets sold after December 31, 2000, that have been held for more than five years, the 10 percent rate is reduced to 8 percent, and for capital assets both purchased and sold after December 31, 2000, that have been held for more than five years, the 20 percent rate is reduced to 18 percent. Because of the post-2000 purchase requirement, the 18 percent rate actually does not generally become effective until January 2, 2006. See infra **¶ 31.02[2][b]**.

Section 1400B provides a complete exemption for capital gains recognized between January 1, 1998, and December 31, 2007, with respect to the sale of certain businesses and business assets operated in the District of Columbia. See supra **¶ 9.10**.

[5] **Section 1091** (see supra **¶ 16.06[3]**) disallows losses on sales of stock or securities if the taxpayer acquires “substantially identical” stock or securities within the period beginning thirty days before and ending thirty days after the sale generating the loss.

[6] For other operational effects of the distinction between the capital gain/loss and ordinary income/loss provisions, see **IRC §§ 170(b)(1)(C)(iv)** and **170(e)(1)** (computation of deduction for charitable contributions), supra **¶ 25.02[2]**; **IRC § 453(i)** (**§ 1245** and **§ 1250** recapture ordinary income not eligible for installment reporting), infra **¶ 41.02[1][b]**.

[7] **IRC § 1239**, discussed infra **¶ 33.05**.