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Applying the new capital gains rules *

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In 1997, when Congress revamped the capital gains rules for eligible property, the maximum rate on net long-term capital gains for an individual was reduced from 28 percent to 20 percent. In addition, the rate for any net long-term capital gain, which would otherwise be taxed at 15 percent, was reduced to a 10 percent rate.

The 1997 Act also provided, beginning in 2001, for an 18 percent rate for long-term capital gains on eligible assets held for more than five years, 8 percent for those in the 15 percent tax bracket. That provision was made effective for property for which the holding period begins after December 31, 2000, except for those in the 15 percent tax bracket. Thus, for those in the 15 percent tax bracket, the holding period for the 8 percent rate could have begun before January 1, 2001. That is not the case for those in higher tax brackets.

Deemed sale

The 1997 Act further specified that taxpayers (other than corporations) and pass-through entities could elect to treat certain assets held on January 1, 2001, as having been sold and reacquired on the same date (often referred to as the market-to-market capital gains election). Any other capital asset or property used in a trade or business for which the election is made, is deemed to have been sold and reacquired on January 1, 2001, for its fair market value on that date. The purpose of the election is to make future gain on an asset eligible for the 18 percent rate (rather than the 20 percent rate). If the irrevocable election is made, any gain on the deemed sale is recognized on the 2001 income tax return; a loss from a deemed sale is not allowed in any tax year. To make the election, taxpayers are to report the deemed sale on a timely filed 2001 income tax return (with extensions).

If the deemed sale results in a loss, the taxpayer is to enter zero instead of the amount of the loss. The taxpayer should attach a statement to the return stating that an election has been made under Section 311 of the Taxpayer Relief Act of 1997 and specify the assets for which the election is made.

Sale of residence

If an individual elects under the Taxpayer Relief Act of 1997 to treat the individual's principal residence as being both sold and reacquired on January 1, 2001, for an amount equal to its fair market value on that date, the individual cannot exclude from gross income the $250,000 residence exclusion ($500,000 on a joint return) any of the gain resulting from the deemed sale. IRS has ruled to that effect on the grounds that the statute requires that gain be recognized “notwithstanding any other provision” of the Internal Revenue Code. Therefore, the gain on the deemed sale is not eligible for the exclusion on sale of the principal residence.

Property sold within one year of deemed election

In late 2000, Congress acted to assure that an election to make a “deemed sale” of assets and recognize gain does not apply to assets disposed of in a recognition transaction within one year of the date the election would otherwise have been effective. Therefore, if an asset is sold in 2001, no election may be made with respect to that asset. In addition, the deemed sale and repurchase by reason of the election is not to be taken into account in applying the “wash-sale” rules. The amendment is designed to prevent a taxpayer from generating a short-term capital loss, which could offset a short-term capital gain from other assets (such as corporate stock).

In conclusion

The changes made in 1997 and 2000 could have important implications for returns filed for the 2001 tax year.

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