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NEW CAPITAL GAINS RULES
— by Neil E. Harl*

The modifications in taxation of long-term capital gains in the Taxpayer Relief Act of 19971 changed, in several respects, the way long-term capital gains are taxed.2 In addition to changes in tax rates,3 and the holding period4 (which was returned to the former requirement of more than one year effective for taxable years ending after December 31, 1997)5 the 1997 legislation imposed new rules on the taxation of gain representing depreciation claimed on Section 1250 property6 at a 25 percent rate.7

A major concern has been how the new 25 percent rate would be imposed on payments under installment contracts or contracts for deed entered into before May 7, 1997, the effective date of the change in capital gains rates.8 On January 22, 1999, proposed regulations were issued providing guidance on how payments on pre-May 7, 1997, contracts as well as those entered into after May 6, 1997, are to be handled.9

“Unrecaptured Section 1250 Gain”

Under the 1997 legislation, for gains from the sale or exchange of Section 1250 property (principally buildings), to the extent the gain would be treated as ordinary income if the property had been Section 1245 property, the gain is taxed at a maximum of 25 percent.10 The gain, referred to as “unrecaptured section 1250 gain”,11 essentially represents the gain attributable to depreciation previously claimed on depreciable real property except for gain recaptured as ordinary income.12 The gain is reduced by any net loss in the 28 percent rate category.13 For Section 1231 assets, the unrecaptured section 1250 gain is not to exceed the net Section 1231 gain for that year.14 Thus, the 25 percent rate category assures recapture of depreciation taken on Section 1250 property. Part of the recapture amount (depreciation in excess of straight line depreciation) is recaptured as ordinary income.15 The rest of the depreciation (generally representing straight line depreciation claimed) is recaptured but at a maximum rate of 25 percent.16

"Front loading" of 25 percent rate recapture

The most significant feature of the new proposed regulations is that the gain taxed at the 25 percent maximum rate—the "unrecaptured section 1250 gain" is front loaded.17 The proposed regulations specify that if a portion of the capital gain from an installment sale is 25 percent gain and a portion is taxed at the 20 percent or 10 percent long-term capital gains rates, the 25 percent gain is to be taken into account before the regular capital gain taxed at the 20 percent or 10 percent rates.18 The IRS was worried that a taxpayer who disposes of an installment obligation at a discount could get by with paying 20 or 10 percent tax instead of the higher 25 percent rate. Thus, the IRS argues that front loading avoids such "inappropriate" results and, moreover, is consistent with the statutory language which defines the gain subject to the 20 percent and 10 percent rates as the residual category of capital gains which is not taxed at the 28 percent or 25 percent rates.19

The front loading applies both to sales before May 7, 1997, and to sales after May 6, 1997.20 The explanation to the proposed regulations clarifies that payments received

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after May 6, 1997, under contracts entered into before May 7, 1997, are eligible for tax treatment the same as sales after May 6, 1997.\(^\text{21}\) The explanation cites to the case of *Shell v. Commissioner*\(^\text{22}\) for the rule that the law in effect when an installment payment is received controls the income tax treatment of the payment. The explanation also cites to the conference committee report on the 1997 act which reaches the same conclusion.\(^\text{23}\)

Front loading for sales before May 7, 1997, may possibly result in none of the gain being taxed at the maximum 25 percent rate--because that portion of the gain had already been reported before May 7, 1997.\(^\text{24}\) However, it will be necessary to go back to the original contract calculations and figure the amount of "unrecaptured section 1250 gain" to see if that segment of the gain would already have been reported (before May 7, 1997) under the front load principle.\(^\text{25}\) That portion of the gain would have been deemed reported before the gain taxed at regular capital gain rates. The proposed regulations contain two examples to illustrate the point.

**Examples illustrating front loading**

In Example 1,\(^\text{26}\) A sells property for $10,000 to be paid in ten equal annual installments beginning on December 1, 1998. A had purchased the property for $5,000 and had claimed straight-line depreciation on the property in the amount of $3,000. In the reporting period for the property (1998 through 2007), A has no other capital or Section 1231 gains or losses.

A's adjusted basis at the time of sale is $5,000-3,000=$2,000. Of the $8,000 of Section 1231 gain on the property, $3,000 is attributable to prior straight-line depreciation which makes it "unrecaptured section 1250 gain". The gain on each annual installment payment of $1,000 is $800. A first takes into account the unrecaptured section 1250 gain. Therefore, the gain for the first three payments (1998, 1999 and 2000) is entirely made up of gain taxed at a maximum of 25 percent. In the fourth payment, in 2001, $600 of the $800 of gain is taxed at 25 percent, completing the reporting of unrecaptured section 1250 gain, and the remaining $200 is taxed at 20 percent. The entire amount of gain in the years 2002 through 2007 ($800 per year) is taxed at 20 percent.

In Example 2, the facts are the same except that A sold the property in 1994, received the first payment on December 1, 1994, and had no other capital or section 1231 gains or losses from 1994 through 2003. As with Example 1, A has $8,000 of gain on the sale of the property with $3,000 as unrecaptured section 1250 gain because of the $3,000 of straight-line depreciation. A's first three payments, in 1994, 1995 and 1996, totalling $3,000, were received before May 7, 1997, and the $2,400 of gain was taxed presumably at 28 percent. That leaves only $600 of gain, out of the December 1, 1997, payment to be taxed at a maximum rate of 25 percent. The remaining $200 of gain on the December 1, 1997, payment and the gain on all subsequent payments would be taxed at regular capital gains rates (20 percent in this example) since the last of the 25 percent rate gain was reported in 1997.

In this example, had the sale occurred in 1993, rather than in 1994, all of the unrecaptured section 1250 depreciation would have been deemed reported and all payments after May 6, 1997, would have been eligible for the 20 percent or 10 percent rates.

**Effective date**

The new proposed regulations are to become effective on the date the regulations become final.\(^\text{27}\) The proposed regulations go on to state that if the amount of unrecaptured section 1250 depreciation in an installment payment taken into account after May 6, 1997, and before the regulations become final is less than the amount prescribed under the proposed regulations, the lesser amount is to be used to determine the amount of unrecaptured section depreciation that remains to be taken into account.\(^\text{28}\) Thus, if a taxpayer spread the unrecaptured section 1250 gain evenly over the payment period, as many thought was the correct approach, that amount (and not the amount had the front load approach been used) must be used in figuring the amount of unrecaptured depreciation yet to be reported.\(^\text{29}\) This may require an amended return for some taxpayers for the 1997 year. However, IRS will not challenge the use of a pro rata allocation method--spreading both the 25 percent gain and the regular capital gain--evenly over the payment period if the taxpayer uses the same pro rata method for all installments during the payment period, including those after the regulations become final.\(^\text{30}\)

### FOOTNOTES

3. I.R.C. § 1(h)(1).
4. I.R.C. § 1(h)(13).
12. I.R.C. § 1(h)(7).
18. *Id.*
22. 97 F.2d 891 (5th Cir. 1938).
25. *Id.*
29. *Id.*
30. See n. 21 supra.