Applying the New Capital Gains Rules

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APPLYING THE NEW CAPITAL GAINS RULES
— by Neil E. Harl

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 mark-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

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cannot exclude from gross income under the $250,000 residence exclusion ($500,000 on a joint return)\textsuperscript{16} any of the gain resulting from the deemed sale.\textsuperscript{17} 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.\textsuperscript{18} Therefore, the gain on the deemed sale is not eligible for the exclusion on sale of the principal residence.\textsuperscript{19}

**Property sold within one year of deemed election**

In late 2000,\textsuperscript{20} Congress acted to assure that an election to make a “deemed sale”\textsuperscript{21} 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.\textsuperscript{22} Therefore, if an asset is sold in 2001, no election may be made with respect to that asset\textsuperscript{23} 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.\textsuperscript{24} 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.

**FOOTNOTES**


3 I.R.C. § 1(h)(1)(B).

4 I.R.C. § 1(h)(2).

5 I.R.C. § 1(h)(2).

6 I.R.C. § 1(h)(2).

7 Id.


9 See note 8 supra.

10 Id.


12 Id.

13 See note 8 supra.

14 See notes 8-12 supra.

15 I.R.C. § 121.


18 See note 19 supra.

19 See notes 8-13 supra.


21 See notes 8-13 supra.

22 See note 19 supra.

23 Id.

24 See I.R.C. § 1091.

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**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

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**BANKRUPTCY**

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**GENERAL-ALM § 13.03.\textsuperscript{a}**

**EXEMPTIONS**

**HOMESTEAD.** The debtor had initially owned a rural residence. The debtor purchased an adjacent parcel of land which had a palm tree nursery on it. The debtor sold palm trees from the land as a business. The debtor filed for Chapter 7 and claimed both parcels as exempt rural homestead property under Fla. Const. art. X, § 4. The creditors objected to the homestead exemption for the palm tree nursery land only, arguing that a homestead could not include commercial property. The court held that the use of a portion of a homestead for business purposes did not disqualify property for the homestead exemption where the commercial use of the property was consistent with the rural character of the property. The court noted that a contrary holding would exclude all farm land from the rural homestead exemption. *In re McLachlan, 266 B.R. 220* (Bankr. M.D. Fla. 2001).

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**FEDERAL TAX-ALM § 13.03[7].\textsuperscript{a}**

**DISCHARGE.** The debtor did not timely file returns for 1987, 1988 and 1989. The IRS prepared substitute returns for those years and made assessments based on the substitute returns. In 1995, as part of an IRS leniency program, the debtor filed returns for those years which were almost identical to the substitute returns used by the IRS. The debtor filed for Chapter 7 in 1999 and sought to discharge the taxes for the years involved. The court held that Section 727 applied to make the taxes nondischargeable because the debtor failed to file a return for the taxes. The court held that the late-filed returns did not constitute returns for purposes of Section 727 because the returns served no purpose. *United States v. Ralph, 266 B.R. 217* (M.D. Fla. 2001).

**SETOFF.** The debtor filed for Chapter 7 on May 19, 1998 and the debtor owed taxes for 1993. The case was considered a no asset case so no tax claim was filed by the IRS. The debtor filed and paid 1997 taxes in August 1998, claiming a refund. The debtor was granted a discharge, including the 1993 taxes, in September 1998. The IRS accepted the 1997 tax return but applied the refund to the 1993 taxes. The debtor sought to reopen the Chapter 7 case

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\*Agricultural Law Manual (ALM).