

Capital Gains

Abstract:

The new 8% capital gain tax bracket is available to taxpayers that are in the 15% tax bracket in 2001 and have held the capital gain assets more than five years. An 18% capital gain rate will be available to taxpayers in 2006 that have sold assets purchased in 2001 or later and held for more than five years. Taxpayers who owned property prior to 2001 may make an election in 2001 to begin the five year holding period. This is treated as an elective sale and will begin the new holding period. The difference between the FMV on the date of election and the original basis will be reported as income in the year of the election. This material discusses the procedures to be taken if the taxpayer desires to make the election.

ISSUE 8: NEW 8% AND 18% CAPITAL GAIN RATES

SECTION 1. THE NEW 8% RATE EFFECTIVE FOR 2001 SALES

Taxpayers in the 15% tax bracket in 2001 are eligible for the lower 8% capital gain rate for sales made in 2001 of property held for **more than five years**. In the examples that follow, these gains are called “**five-year gains**” to differentiate them from 2001 gains where the five-year holding period was not met. The latter are called “**other capital gains**” in the examples.

The lower 8% capital gain rate applies only to capital gains that would have been taxed at the old 10% rate. The amount of 2001 taxable income is an important factor in determining whether a 2001 capital gain will be taxed at 8% or 20%. The new 2001 Tax Rate Schedules for Single and for Married Filing Jointly are shown as follows, to assist in analyzing the examples.

SINGLE—SCHEDULE X				
If Taxable Income Is:		The Tax Is:		
<i>Over</i>	<i>But No Over</i>			<i>Of the Amount Over</i>
\$ -0-	\$27,050	.....	15%	\$ -0-
\$ 27,050	\$ 65,550	\$ 4,057.50 +	27.5%	\$ 27,050
\$ 65,550	\$136,750	\$14,645.00 +	30.5%	\$ 65,550
\$136,75	\$297,350	\$36,361.00 +	35.5%	\$136,7

0				50
\$297,350	.....	\$93,374.00 +	39.1%	\$297,350

MARRIED FILING JOINTLY OR QUALIFYING WIDOW(ER)—SCHEDULE Y-1				
If Taxable Income Is:		The Tax Is:		
<i>Over</i>	<i>But No Over</i>			<i>Of the Amount Over</i>
\$ -0-	\$ 45,200	.....	15%	\$ -0-
\$ 45,200	\$109,250	\$ 6,780.00 +	27.5%	\$ 45,200
\$109,250	\$166,500	\$24,393.75 +	30.5%	\$109,250
\$166,500	\$297,350	\$41,855.00 +	35.5%	\$166,500
\$297,350	.....	\$88,306.75 +	39.1%	\$297,350

Example 1. Sam is single. His 2001 income and deductions exclusive of capital gains are shown below.

Salary income	\$30,000
Less: Standard deduction	(4,550)
Less: Exemption (1)	<u>(2,900)</u>
2001 Taxable income before capital gains	\$22,550

The \$22,550 shown above is **\$4,500 less** than the \$27,050 ceiling for the 15% tax bracket. Therefore, the maximum amount of **five-year gains** that will qualify for the lower 8% rate is \$4,500.

Sam owns 500 shares of stock that he inherited from his uncle in 1990. He sells it in 2001 and realizes a \$20,000 long-term capital gain. This is a **five-year gain** and qualifies for the lower 8% rate.

Question 1. What portion of Sam's \$20,000 **five-year gain** on the stock sale is eligible for the new 8% capital gain rate?

Answer 1. \$4,500.

Question 2. How much tax will Sam owe in 2001 on the \$20,000 five-year gain?

Answer 2. \$3,460. See below for the computations.

\$4,500 8%	\$ 360
The balance of the \$20,000 gain is \$15,500.	
\$15,500 20%	<u>3,100</u>
Tax Sam will owe on the five-year gain	\$3,460

Example 2. Chris and Anna file a joint return for 2001. Chris is employed and Anna stays home to care for their child. Their 2001 income and deductions exclusive of capital gains are shown below.

Chris's salary	\$ 65,000
Less: Itemized deductions (taxes and interest)	(15,000)
Less: Exemptions (3 X \$2,900)	<u>(8,700)</u>
2001 Taxable income before capital gains	\$ 41,300

The \$41,300 shown above is **\$3,900 less** than the \$45,200 ceiling for the 15% tax bracket. Therefore, the maximum amount of **five-year gains** that will qualify for the lower 8% rate is \$3,900.

Chris and Anna made two stock sales in 2001. The details of the two sales are shown next.

Five-year gain on employer stock	\$2,000
Other capital gain on stock held for 3 years	<u>5,000</u>
Total 2001 long-term capital gain	\$7,000

Question 1. How much tax will Chris and Anna owe in 2001 on the two long-term capital gains?

Answer 1. \$970. See below for the computations.

1. All of the \$2,000 **five-year gain** is taxed at 8% as it is less than \$3,900.
\$2,000 X 8% \$160
2. \$1,900 remains of the \$42,500 tax bracket (\$3,900 the five-year gain of \$2,000) Therefore, the first \$1,900 of the \$5,000 **other capital gain** is taxed at 10%
\$1,900 X 10% 190
3. The \$3,100 remainder of the \$5,000 **other capital gain** is taxed at 20%
\$3,100 X 20% 620

Total tax owed on the \$7,000 of long-term gains

\$970

SUMMARY FOR SECTION 1

This rate reduction will benefit taxpayers in the 15% tax bracket in 2001. Due to the significant increase in the last decade in the percentage of those who own stock, many taxpayers may benefit from the lower 8% rate in 2001. That, of course, assumes that they were wise or lucky and sold stocks at a gain in 2001 that they held for more than five years. That assumption may be optimistic, considering the stock market performance of 2001.

From a planning perspective, practitioners might want to advise clients in the 15% tax bracket to keep appreciated stocks for five years and a day for 2001 and later sales. Of course, that advice may be wrong if an appreciated stock held less than five years and a day turns into a losing stock held for five plus years.

SECTION 2. THE NEW 18% RATE THAT WILL BE EFFECTIVE FOR 2006 SALES AND THE POTENTIAL ELECTION ON THE 2001 TAX RETURN

Taxpayers who owned property before 2001 may make a deemed sales election for 2001 to restart the holding period with a new basis equal to fair market value on the election date. Any gain must be recognized; any loss is not deductible. No regulations have been issued, but the following guidance was included in the 2000 Instructions for Form 4797 and IRS Publication 553. Technical corrections to TRA 97 enacted in 2000 have been incorporated.

1. Taxpayers (other than corporations) and pass-through entities may elect to treat certain assets held on January 1, 2001, as having been sold and then reacquired on the same date (commonly called the mark-to-market capital gain election).
2. Pass-through entities include mutual funds, real estate investment trusts, S corporations, partnerships, estates, trusts, and common trust funds. For grantor trusts, the grantor of the trust must make the election.
3. Any readily tradable stock owned and not sold before January 2, 2001, for which the election is made, is deemed to have been sold January 2, 2001, at its closing market price and reacquired on that date for the same amount.

Practitioner Note. Readily tradable stock includes shares issued by an open-end mutual fund.

4. Any other capital asset or property used in a trade or business (I.R.C. §1231 property) held for the entire year of 2001, 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. This can include a taxpayer's interest in a pass-through entity.

5. The purpose of the election is to make future gain on the asset eligible for an 18% (instead of 20%) capital gain tax rate.

Practitioner Note. The 18% rate won't begin until sales of capital assets in 2006. The reason for this is that a capital asset, the holding period for which begins after 2000, must be held for more than five years. The new 18% capital gain rate beginning in 2006 will benefit taxpayers in the 25% and higher tax brackets.

6. If the election is made, any **gain** on a deemed sale **must be recognized** on the 2001 tax return. A **loss** from a deemed sale is **not allowed** in any tax year, but the asset will be eligible for the 18% rate on any future gain. The election is irrevocable.
7. To make the election, report the deemed sale(s) on a timely filed (including extensions) 2001 tax return. If the deemed sale results in a loss, enter zero instead of the amount of the loss. Attach a statement to the return, stating that an election has been made under I.R.C. §311 of the Taxpayer Relief Act of 1997 and specify the asset(s) for which the election is made. A sample election follows.

Practitioner Note. If no election is made on the timely filed 2001 tax return, an amended return (2001

Form 1040X) can be filed for a calendar-year taxpayer to make the election. In this case, the 2001 Form 1040X must be filed **no later than October 15, 2002**. At the top of the 2001 Form 1040X, write: "**Election Under I.R.C. §311 of the Taxpayer Relief Act of 1997.**" See pp. 440–443 of the *1999 Farm Income Tax School Workbook* for information regarding late elections.

8. The gains shown below do **not** qualify for either the new lower 8% or 18% capital gain rates:
 - Gain on sale of collectibles
 - I.R.C. §1202 gain (from sale of qualified small business stock)
 - Unrecaptured I.R.C. §1250 gain (this gain due to depreciation deductions on real estate will continue to be taxed at a maximum 25% tax rate)

The following **planning examples** are provided to help practitioners make election decisions that **might** be beneficial to clients. The word "**might**" is very appropriate because the required five-year holding period to take advantage of the lower 18% rate is a very long time. It is very difficult to make a planning

decision in 2002 (for 2001 tax returns) without a crystal ball that shows what 2006 will bring.

Sample Election			
Election under §311 of the Taxpayer Relief Act of 1997			
Name		Taxpayer identification number	
Tax form number		Tax year ending date	
Description of Property	Date Acquired	Fair market value on valuation date	
		\$	
		\$	
		\$	

Example 3. Lois, a single individual, owns 200 shares of stock that she purchased in 1998 for \$40 a share. The stock's closing price on January 2, 2001, was \$42. She is a long-term investor and will probably hold the stock until 2006. Her 2001 salary is \$95,000.

Question 1. With these facts, should you advise Lois to make the mark-to-market election for the stock on her 2001 timely filed tax return?

Answer 1. Probably. Her paper gain is only \$400 (200 shares \$2 price increase) on January 2, 2001. Her tax cost on the elected gain is only \$80 (\$400 gain 20%). This assumes she has net capital gain income in 2001. If the stock appreciates, any subsequent gain in 2006, or in a later year when she sells the stock, will be taxed at 18%.

Now, assume the same facts for Lois as in Example 3, and that the election was not made on her timely filed 2001 return. Also assume that on September 30, 2002, the stock closed at \$130 a share.

Question 2. Should you consider filing a 2001 Form 1040X for her by the October 15, 2002 deadline to make the election?

Answer 2. Yes. Knowing the price of the stock in 2006 is impossible on September 30, 2002 but the \$88 increase in price indicates there may be a large gain on the ultimate sale. Therefore, the extra \$80 tax cost in making the election on Lois's amended 2001 return certainly appears to be smart tax planning.

Example 4. Ted owns 500 shares of stock that he bought in 1999 for \$20 a share. The stock's closing price on January 2, 2001, was \$60. Ted is a long-term investor and expects to hold the stock until 2006. Ted has \$15,000 long-term capital loss carryover to 2001. He also has net realized long-term capital losses of \$8,000 for 2001 transactions, including capital gain dividends. He had no short-term transactions in 2001.

Question 1. Should Ted make the election on his 2001 timely filed return to report the \$20,000 (500 shares \$40 price increase) paper gain?

Answer 1. He should consider making the election since the result will be no change to Ted's 2001 tax liability. With the \$20,000 elected paper gain, Ted will have a net \$3,000 long-term capital loss for 2001 (\$23,000 of losses less the \$20,000 elected paper gain). Any future appreciation of the 500 shares will be taxed at 18% rather than 20% if they are held until 2006 or later. However, making the election could be detrimental to Ted if he has capital gains soon after 2001 that would have been offset by the \$20,000 capital loss carryover.

Example 5. Jim bought 1,000 shares of stock in 1998 for \$5 a share. The stock's closing price on January 2, 2001, was \$12. On March 1, 2002, before you prepare Jim's 2001 return, he sold the stock for \$20 a share. His only other 2001 long-term gain is \$1,000 of capital gain dividends.

Question 1. Should Jim make the election on his 2001 return to report the \$7,000 (1,000 shares \$7 price increase) paper gain?

Answer 1. Jim should consider making the election if he has an unused 10% bracket in 2001. By making the election, the \$15,000 long-term gain (1,000 shares \$15 price increase) can be **split between two tax years**. The \$7,000 elected paper gain (1,000 shares \$7 price increase as of January 2, 2001) will be reported in **2001**, along with the \$1,000 capital gain dividends.

The remaining \$8,000 long-term gain will be reported on Jim's **2002** return. His \$8,000 **2002** gain is computed as follows:

Sales price (1,000 shares X \$20) on March 1, 2002	\$ 20,000
Less: Mark-to-market elected cost (1,000 shares X \$12 closing price on Jan. 2, 2001)	<u>(12,000)</u>
2002 realized gain	\$ 8,000

SUMMARY FOR SECTION 2

The previous examples in Section 2 involve stock sales. However, the election can be made for **any other capital asset**, for example, a vacant lot held for speculative purposes. The election can also be made for I.R.C. §1231 business property. **Examples:** (1) **farmland** owned by a farmer or landlord, or a (2) **warehouse** owned by an S corporation.

Example 6. Roger, an operating farmer, bought 100 acres of farmland in 1998 for \$3,000 per acre. He farms the land. The fair market value of the 100 acres on January 1, 2001, is \$3,200 per acre. Due to recent development trends, he thinks the land could sell for \$10,000 an acre by 2006. Assume he has no other 2001 capital transactions. If he makes the election on his 2001 return, he will pay \$4,000 tax on the phantom \$20,000 gain (\$20,000 20% \$4,000 tax).

Example 6 Analysis. If he **makes the election** in 2001 and sells the land in March 2006 for \$10,000 per acre, **his 2006 gain will be \$680,000** (\$1 million sales price less \$320,000 cost basis). His 2006 tax on the gain will be \$122,400 (\$680,000 18%).

If he **doesn't make the 2001 election**, **his 2006 gain will be \$700,000** (\$1 million sales price less \$300,000 cost basis). His 2006 tax on the sale will be \$140,000 (\$700,000 20%).

The overall tax savings from making the election is \$13,600 (\$140,000 \$4,000 \$122,400). However, an I.R.C. §1031 tax-deferred exchange in 2006 would be the preferred tax-saving strategy, assuming Roger does not want or need \$1 million in cash in 2006.

Some tax advisors are suggesting this strategy: Prepare timely filed 2001 Forms 1040 with no election. Then review the facts in September 2002 to determine if an election on an amended return makes tax sense. The 2001 Form 1040X must be filed no later than October 15, 2002. See the boxed note on page 197 for details.

Practitioner Caution. One danger in making the election on the 2001 return is that the taxpayer **might be in the 15% tax bracket when the asset is sold** in 2006 or a later year. In that case, the 2001 election would **needlessly accelerate the tax** on the phantom gain. The reason is that the gain in 2006 or a later year would be taxed at 8% without the election. This assumes, of course, that current tax laws do not change before 2006!

One planning issue that surfaced has been refuted by IRS. The 2001 Schedule D Instructions will explain that a deemed sale of a **personal residence** on the 2001 Form 1040 **cannot** be followed by an I.R.C. §121 exclusion of the gain. The authority is I.R.C. §311(e)(2)(A) of the Tax Relief Act of 1997, which

states that any gain resulting from the election “shall be recognized notwithstanding any provision of the Internal Revenue Code of 1986.”

Finally, 2006 is relatively far in the future. Predicting future tax law changes is impossible. The lower 18% capital gain rate is a planning issue. What appears to be wise tax planning in 2001 can in reality become unwise in 2006 due to factors over which a practitioner has no control.