Tax Report #947

New York State Bar Association

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The Hon. Bill Archer
Chair, House Ways & Means Committee
1236 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Archer:

This letter[1] sets forth the concerns of the Tax Section of the New York State Bar Association regarding the complexity fostered by certain amendments to Section 1(h)[2] enacted pursuant to Section 311 of the Taxpayer Relief Act of 1997 ("TRA 1997"). Pursuant to these amendments, the maximum capital gains rate was reduced to 18% for gains from the sale of property acquired after December 31, 2000 and held for more than five years (the "super long-term holding period"). In addition, under Section 311(e) of TRA 1997, taxpayers may elect to treat capital assets held on January 1, 2001 as if they were sold and reacquired on that date to obtain the benefit of the 18% rate upon their sale after being held for more than five years (the "deemed sale election").

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1 This letter was written by Lisa A. Levy with the substantial assistance of Harold R. Handler and David S. Miller. Helpful comments were received from Robert Cassanos, Robert Jacobs, Richard O. Loengard, Jr., Michael Schler and David Schizer.

2 Except as otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder.

As discussed in more detail below, we believe that these provisions exacerbate the complexity of the Code's capital gains and holding period rules, and thus may not be justifiable in light of the relatively small reduction in capital gains tax achieved.

Background. Under Section 1(h)(1), net capital gain recognized by non-corporate taxpayers from the sale or exchange of property held for more than one year generally is taxed at a maximum rate of 20%, and at 10% for net capital gains recognized by taxpayers in the 15% tax bracket. [3]

Under Section 1(h)(2), amended by TRA 1997, in the case of any taxable year beginning after December 31, 2000, net capital gain to which the 10% rate would otherwise apply will be taxed at a maximum rate of 8% to the extent derived from the sale or exchange of property held for more than five years ("Qualified 5-Year Gain"), regardless of when the property was acquired. Qualified 5-Year Gain that would otherwise be taxed at the 20% rate will be taxed at a maximum rate of 18%, but only if the holding period of the property disposed of began after December 31, 2000. Finally, for this purpose, the holding period of an option (or other right or obligation to acquire property) pursuant to which the property was acquired will be taken into account to determine whether the holding period of the property began after December 31, 2000.

Under Section 311(e) of TRA 1997, a taxpayer holding a capital asset or an asset used in the taxpayer's trade or business on January 1, 2001 may elect to treat the asset as having been sold and reacquired on

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3 Net capital gain is the excess of net long-term capital gain over net short-term capital loss for the taxable year. Section 1222(11). Net long-term capital gain is the excess of long-term capital gain over long-term capital losses for the taxable year. Section 1222(7). Net short-term capital loss is the excess of short-term capital losses over short-term capital gains for the taxable year. Section 1222(6).

Capital gain derived from the sale or exchange of collectibles (as defined in Section 408(m)) held for more than one year and certain small business stock under Section 1202 is taxed at a maximum rate of 28%, and long-term capital gain from the sale of section 1250 property is taxed at a maximum rate of 25% to the extent such gain would have been treated as ordinary income had the property been section 1245 property.

that date for an amount equal to its fair market value; if the election is made, the taxpayer will recognize gain (but any loss will not be allowed for any taxable year), and the asset will be eligible for the 18% rate if sold after being held for the super long-term holding period.

Complexity. The addition of the super long-term holding period greatly increases the existing complexity inherent in the capital gains and holding period provisions of the Code.[4] First, in addition to keeping track of property with short-term and long-term holding periods, certain non-corporate taxpayers and entities required to report tax information to non-corporate taxpayers must now keep track of property held for more than five years that was acquired before January 1, 2001 (because gain from the sale of the property, if recognized by a taxpayer in the 15% bracket, will be eligible for the 8% rate). After December 31, 2000, all non-corporate taxpayers and reporting entities will be required to keep track of property held for more than five years[5] and to undertake

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4 Administrative guidance regarding the computations and information reporting required to comply with the current capital gains provisions, and the requisite conforming amendments that will be made to certain provisions of the Code, are set forth in Announcement 97-109, 1997-45 I.R.B. 12, Notice 97-59, 1997-45 I.R.B. 7, Notice 97-64, 1997-47 I.R.B. 7, and Notice 98-20, 1998-13 I.R.B. 25. These administrative pronouncements, which undoubtedly will be followed by more, begin to demonstrate the complexity created by the 1997 amendments to Section 1(h).

5 A related issue is application of the holding period rules to sales of interests in partnerships. For example, assume a taxpayer sold an appreciated partnership interest that was acquired after January 1, 2001 and held for more than 5 years and that a large portion of the taxpayer's gain was attributable to his share of unrecognized gains in partnership capital assets held for less than 5 years or acquired prior to January 1, 2001. Section 741 provides that gain from the sale of a partnership interest is treated as capital gain, except as otherwise provided in Section 751. Under Section 751, proceeds from the sale of a partnership interest generally are treated as from the sale of property other than a capital asset to the extent attributable to partnership assets whose sale by the partnership would generate ordinary income. Thus, under current law, the taxpayer's entire capital gain from the sale of the partnership

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complex rate computations.[6] Second, taxpayers will be required to apply intricate rules to allocate net capital losses to yet another category of net capital gain.[7] Similar concerns regarding complexity led Congress to

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interest would nevertheless be taxed at the 18% rate.

6 To illustrate the extent of the complexity involved, consider a taxpayer who recognized net capital gains in 2007 from the sale of collectibles, section 1250 properties, and all of her shares of a mutual fund that were initially acquired in 1999 and the dividends from which were reinvested in additional shares. This taxpayer will be required to apply five different tax rates to her net capital gains: (i) 28% to net capital gain from the sale of collectibles, (ii) 25% to net capital gain from the sale of section 1250 properties, (iii) the applicable ordinary income rate to net gain from the sale of shares held for one year or less, (iv) 20% to net capital gain from the sale of shares held for more than one year, including shares held for more than five years that were acquired prior to January 1, 2001, and (v) 18% to shares held for more than five years that were acquired after December 31, 2000. If this taxpayer recognized net losses in a particular rate group, she would have to apply the complicated netting rules discussed below to compute the amount of her net capital gain in the other rate groups.

7 Notice 97-59, 1997-45 I.R.B. 7, provides guidance on the netting of gains and losses under current law:

Within each group, gains and losses are netted to arrive at a net gain or loss. Taking into account the pending legislation, the following additional netting and ordering rules apply:

(1) SHORT-TERM CAPITAL GAINS AND LOSSES. As under prior law, short-term capital losses (including short-term capital loss carryovers) are applied first to reduce short-term capital gains, if any, otherwise taxable at ordinary income rates. A net short-term capital loss is then applied to reduce any net long-term capital gain from the 28-percent group, then to reduce gain from the 25-percent group, and finally to reduce net gain from the 20-percent group.

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repeal the 28%/20% rate dichotomy established under TRA 1997, and we believe they warrant reconsideration of the 18% rate.

We are also concerned that the enactment of the super long-term holding period and the deemed sale election may encourage taxpayers to enter into tax-motivated transactions involving financial derivatives, and will require additional anti-abuse provisions, further increasing complexity of the holding period rules. For example, taxpayers may attempt to qualify for the 18% rate by holding property for more than five years while entering into derivative financial instruments to diminish their risk of loss with respect to the property.[8] Alternatively, to take the position that the holding period of an asset began after December 31, 2000, taxpayers may enter into short sales or Section 1092 straddle transactions with respect to short-term property held prior to that date and

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(2) LONG-TERM CAPITAL LOSSES. A net loss from the 28-percent group (including long-term capital loss carryovers) is used first to reduce gain from the 25-percent group, then to reduce net gain from the 20-percent group. A net loss from the 20-percent group is used first to reduce net gain from the 28-percent group, then to reduce gain from the 25-percent group.

Any resulting net capital gain that is attributable to a particular rate group is taxed at that group's marginal tax rate.

8 Under Reg. Section 1.1092-2T(a), the holding period of an asset that has been held for more than one year will not be terminated or suspended if the taxpayer enters into a derivative financial instrument that creates a Section 1092 straddle with respect to the asset. Further, if the derivative financial instrument is sufficiently out-of-the money, the taxpayer should not be treated as having entered into a constructive sale of the asset under Section 1259(a) (which, if it were applicable, would result in the holding period being determined as if the asset were originally acquired on the date of the constructive sale). Thus, under current law, a taxpayer could acquire a capital asset in 2001, hold it unhedged for a year and a day, and then reduce his risk of loss with respect to the asset, sell the asset four years later and qualify for the 18% rate.

terminate the transactions after that date, [9] or grant certain types of in-the-money call options with respect to stock which remain outstanding throughout the taxpayer's entire pre-2001 holding period for the stock.[10] In addition, taxpayers may enter into transactions that suspend the holding period of property with a built-in loss to net the loss, when recognized, against capital gains taxed at 20%, rather than 18%.[11] Thus, the deemed

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9 If a taxpayer enters into a short sale of an asset, under Section 1233(b), the holding period of substantially identical property held by the taxpayer at the time of the short sale or that is acquired thereafter will not begin until the date the short sale is closed. Similarly, if a taxpayer enters into a Section 1092 straddle with respect to an asset held for one year or less, under Reg. Section1.1092-2T(a), the holding period of the asset will not begin until the straddle is terminated. Since the 18% rate would apply to property whose holding period begins on or after January 1, 2001 (even if it was purchased before that date), under current law, the strategy described in the text would appear to be successful.

10 Under Section 1092(f), the holding period of stock does not include any period during which the taxpayer is a grantor of a qualified covered call option to purchase the stock with a strike price less than the most recent closing price for the stock prior to the date the option was granted (or, in certain circumstances, the opening price for the stock on the date the option was granted).

11 Under Reg. Section 1.1092(b)-2T(b)(1), loss on the disposition of a position that is part of a Section 1092 straddle established when the loss position was acquired will be treated as long-term capital loss if one or more positions in the straddle was held for more than one year on the date the loss position was acquired or entered into. For example, consider a taxpayer who anticipates recognizing a capital gain taxable at 20% in 2006 and wants to generate a partially offsetting capital loss in that year. Assume the taxpayer holds an asset acquired on January 1, 2001 which she anticipates will appreciate in value during 2005. Apparently, the taxpayer may be able to achieve this objective by entering into a short position with respect to that asset in the beginning of 2005 which creates a Section 1092 straddle. If, as expected, the asset appreciates in 2005 and the short-position suffers an offsetting decline in value in that year, in 2006, the taxpayer can sell the asset at a gain, which

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sale election likely will require a whole regime of tax avoidance provisions to prevent abuse.

Further, taxpayers will be motivated to enter into "self-help" transactions to avoid the restrictive timing of the deemed sale election and the disallowance of losses realized as a result of the election. For example, a taxpayer who holds an appreciated capital asset on January 1, 2001 can forego the deemed sale election and subsequently accomplish the same result by entering into a transaction that constitutes a constructive sale of that asset under Section 1259,[12] or the taxpayer can merely sell the appreciated asset and reacquire it on the next day. Similarly, a taxpayer who holds a capital asset on January 1, 2001 with a built-in loss can sell the asset, recognize the loss and reacquire the asset after 30 days, thereby avoiding application of the wash sales rules.[13]

Yet another concern is that the deemed sale election may be a trap for unwary taxpayers, as a complicated analysis is necessary to

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would be taxed at 18%, and close the short position at a loss, which would be netted against long-term capital gains taxed at 20%. A similar result apparently could be achieved if the taxpayer held stock that was acquired on January 1, 2001 and had a built-in loss as of the beginning of 2005 which the taxpayer expected would increase during 2005. On January 1, 2005, to hedge against a further decline in the stock's value, the taxpayer sells an out-of-the money qualified covered call option with respect to the stock which expires on January 2, 2006. It appears that, if the taxpayer sold the stock at a loss on January 2, 2006, the loss would be netted against capital gain taxable at 20% because the holding period of the stock was suspended as of January 1, 2005 under Section 1092(f)(2).

12 Under Section 1259(a), a taxpayer will be treated as having made a constructive sale of an appreciated asset if he enters into certain offsetting transactions with respect to the asset (e.g., a short sale of the asset or a forward or futures contract to deliver the asset). The holding period of an appreciated asset that is treated as constructively sold is determined as if the asset were originally acquired on the date of the constructive sale.

13 <u>See</u> Section 1091(a).

determine whether the election is beneficial and most taxpayers will not reap significant benefits from prepaying taxes to obtain a 2% rate reduction five or more years later.[14] Moreover, even if a taxpayer determines it is beneficial to make the election with respect to an asset, several factors outside the taxpayer's control may eliminate the anticipated benefits: the taxpayer may die before selling the asset or may be in the 15% tax bracket when the asset is sold (and thus did not need to make the election to obtain the 2% rate reduction), or the taxpayer ultimately may sell the asset at a loss. In addition, subsequent amendments to the Code may reduce or eliminate the benefits of having made the election. As a consequence, most sophisticated or well-advised taxpayers will not make the election, while uninformed taxpayers may make the election although it is ultimately economically disadvantageous to do so.

Finally, because the deemed sale election is applicable to property used in a trade or business, we are concerned that the deemed sale election may create difficult valuation issues for both taxpayers and the Internal Revenue Service. Taxpayers may be motivated to undervalue appreciated business property, thereby involving the Internal Revenue Service in a large number of valuation disputes with taxpayers.

For these reasons, we suggest that this super long-term holding period establishes needless complexity in accomplishing a relatively small rate reduction for assets which are held for a long period of time.[15] The advantages that already exist in the Code for long held

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14 Two university professors and a Federal Reserve economist have concluded, based on complicated mathematical analyses that take into account the unrealized appreciation, expected price appreciation, expected holding period and expected and present current income with respect hypothetical investments in stock, that a taxpayer will benefit from the deemed sale election only if the unrealized appreciation in the asset in question is less than approximately 14% as of January 1, 2001. The economist also concluded that even when the election is beneficial the net benefit is extremely small. Franklin Lowenthal and Philip Storer, "Capital Gains: Should One Elect to Mark to Market in 2001?" Tax Notes Today (May 26, 1998); Alan Viard, "More on Whether to Mark to Market in 2001," Tax Notes Today (Sept. 28, 1998).

15 Another alternative would be the reinstatement of a deduction for a (continued...)

assets, i.e., deferral of tax until recognition of the gain, the possibility of complete avoidance of income tax upon death, the ability to make tax efficient transfers of appreciated property to charities or heirs, etc., are significant benefits without the further complexity caused by one more rate class for certain long held assets.

Very truly yours,

Harold R. Handler
Chair

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portion of long-term capital gains that would be uniformly available to all taxpayers. However, this might create its own complexity for taxpayers where the calculation of taxable income is relevant for other tax provisions, i.e. net operating loss carryovers, or for states that use federal taxable income as a basis for computing state taxable income, as such taxpayers would have to add back the deduction for federal or state income tax purposes.