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**Issue Contents**

**Bankruptcy**

Federal taxation  
Discharge **115**

**Federal Agricultural Programs**

Beef check-off **115**  
Disaster payments **115**  
Guaranteed loans **115**  
Tobacco **115**

**Federal Estate and Gift Tax**

Adjusted taxable gifts **115**  
Administrative expenses **115**  
IRA **116**  
Marital deduction **116**  
Valuation **116**

**Federal Income Taxation**

Bad debts **116**  
Capital gains and losses **116**  
Charitable deduction **116**  
Cooperatives **116**  
Corporations  
Shareholder loans **117**  
Disaster payments **117**  
Discharge of indebtedness **117**  
Earned income credit **117**  
Electricity production credit **117**  
Employee benefits **117**  
Hobby losses **117**  
IRA **118**  
Partnerships  
Distributive share **118**  
Passive activity losses **118**  
Pension plans **118**  
Returns **118**  
Safe harbor interest rates  
July 2002 **119**  
Tax on social security benefits **119**  
Withholding taxes **119**

**In the News 119**

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## “DEEMED SALES” OF CAPITAL AND SECTION 1231(b) ASSETS

— by Neil E. Harl\*

The Taxpayer Relief Act of 1997,<sup>1</sup> in reducing the rates on long-term capital gains,<sup>2</sup> reduced the rates further from 10 percent to 8 percent and from 20 percent to 18 percent for assets held for more than five years.<sup>3</sup>

### Nature of the “deemed sale”

Except for those in the 15 percent bracket, the holding period had to begin after December 31, 2000.<sup>4</sup> That meant that, in general, the provision authorizing an 18 percent rate did not take effect until 2006. However, Section 311(e) of The Taxpayer Relief Act of 1997,<sup>5</sup> which was not added to the Internal Revenue Code, contains a “deemed sale” provision which permits taxpayers effectively to sell and repurchase eligible assets effective January 1, 2001, with the eligible assets deemed sold on January 1, 2001, and immediately repurchased at the same value with a triggering of gain (but not loss). That maneuver starts the holding period for the reduced long-term capital gain rate of 18 percent.<sup>6</sup>

The statutory guidance for deemed sales states as follows

“For purposes of the Internal Revenue Code of 1986

“(1) In General.—A taxpayer other than a corporation may elect to treat

“(A) Any readily tradable stock (which is a capital asset) held by such taxpayer on January 1, 2001, and not sold before the next business day after such date, as having been sold on such next business date for an amount equal to its closing market price on such next business day (and as having been reacquired on such next business day for an amount equal to such closing market price), and

“(B) Any other capital asset or property used in the trade or business (as defined in section 1231(b) of the Internal Revenue Code of 1986) held by the taxpayer on January 1, 2001, as having been sold on such date for an amount equal to its fair market value on such date (and as having been reacquired on such date for an amount equal to such fair market value).

“(2) Treatment of gain or loss

“(A) Any gain resulting from an election under paragraph (1) shall be treated as received or accrued on the date the asset is treated as sold under paragraph

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announcement for print subscribers.**

(1) and shall be included in gross income notwithstanding any provision of the Internal Revenue Code of 1986.

“(B) Any loss resulting from an election under paragraph (1) shall not be allowed for any taxable year.

“(3) Election.—An election under paragraph (1) shall be made in such manner as the Secretary of the Treasury or his delegate may prescribe and shall specify the assets for which such election is made. Such an election, once made with respect to any asset, shall be irrevocable. Such an election shall not apply to any asset which is disposed of (in a transaction in which gain or loss is recognized in whole or in part) before the close of the 1-year period beginning on the date that the asset would have been treated as sold under such election.

“(4) Readily tradable stock. For purposes of this subsection, the term ‘readily tradable stock’ means any stock which, as of January 1, 2001, is readily tradable on an established securities market or otherwise.

“(5) Disposition of interest in passive activity. Section 469(g)(1)(A) of the Internal Revenue Code of 1986 shall not apply by reason of an election under paragraph (1).”<sup>7</sup>

#### Eligible property

As noted,<sup>8</sup> capital assets are eligible for the deemed sale election and depreciable property and real estate used in a trade or business<sup>9</sup> and held for more than one year, are also eligible.<sup>10</sup> That is the case even though much or all of the gain on depreciable property may be subject to recapture as ordinary income.<sup>11</sup>

#### Making the election

The election is made by reporting the deemed sale on Form 4797 and Schedule D, for the respective types of property, and attaching a statement indicating that an election is being made under Section 311(e) of the Tax Reform Act of 1997.<sup>12</sup> The statement is to include a listing of the assets for which the election is being made. As noted above, the election, once made, is irrevocable.<sup>13</sup>

The tax return must be filed not later than the due date (including extensions). For those who have already filed their returns for 2001, an election can be made on an amended return filed within six months of the due date for the tax return (excluding extensions).<sup>14</sup> Taxpayers are directed to write “Election Under Section 311 of the Taxpayer Relief Act of 1997” at the top of the amended return.<sup>15</sup>

#### Recent developments

In 2000, Congress amended the deemed sale provision to specify that the election to recognize gain and start a new five-year holding period for the 18 percent capital gain rate does not apply to property sold within one year of the election.<sup>16</sup> In 2001, IRS ruled that if the election was made with respect to a principal residence, the \$250,000 exclusion (\$500,000 on a joint return)<sup>17</sup> is not available. In 2002, the Congress added that any gain triggered in a deemed sale must be included in gross income regardless of any other provision of the Internal Revenue Code.<sup>18</sup> In the same legislation, Congress specified that a deemed sale of an asset with passive activity losses does not result in a deduction of those losses.<sup>19</sup> The election, however, does not affect I.R.C. § 469 as to “dispositions.”<sup>20</sup> Gains that are passive can be offset by passive activity deductions but the election does not affect disallowed losses.<sup>21</sup>

#### In conclusion

A major question is whether a deemed sale election is likely to be advantageous. That is heavily a facts and circumstances question for each taxpayer.<sup>22</sup>

#### FOOTNOTES

<sup>1</sup> Pub. L. No. 105-34, Sec. 311(e), 111 Stat. 836 (1997). See Harl, “Taxpayer Relief Act of 1997 (H.R. 2014): Summary of Selected Provisions,” 8 *Agric. L. Dig.* 113 (1997); Harl, “New Capital Gains Rules,” 9 *Agric. L. Dig.* 9 (1998). See generally 4 Harl, *Agricultural Law* § 27.06 (2002).

<sup>2</sup> I.R.C. § 1(h)(1).

<sup>3</sup> I.R.C. § 1(h)(2), (9).

<sup>4</sup> I.R.C. § 1(h)(2)(B).

<sup>5</sup> See n. 1 *supra*.

<sup>6</sup> *Id.* See I.R.C. § 1(h)(2)(B), (9).

<sup>7</sup> TRA-97, Sec. 311(e), as amended by H.R. 4577, Sec. 134(c), 106th Cong., 2d Sess. (2000) and Pub. L. No. 107-147, Sec. 414(a).

<sup>8</sup> *Id.*

<sup>9</sup> I.R.C. § 1231(b).

<sup>10</sup> See n. 7 *supra* and accompanying text.

<sup>11</sup> *Id.*

<sup>12</sup> See Instructions to 2001 Form 4797 and 2001 Schedule D.

<sup>13</sup> TRA-97, Sec. 311(e)(3). See n. 7 *supra* and accompanying text.

<sup>14</sup> See note 12 *supra*.

<sup>15</sup> 2001 Schedule D Instructions, p. D-2; 2001 Form 4797 Instructions, p. 3.

<sup>16</sup> Pub. L. No. 106-554, Sec. 134(c), 106th Cong., 2d Sess. (2000) (the provision effectively eliminated the ploy of generating short-term capital losses by selling assets within one year of the deemed disposition date).

<sup>17</sup> I.R.C. § 121.

<sup>18</sup> Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, Sec. 414(a)(1), amending Sec. 311(e)(2)(A) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 836 (1997).

<sup>19</sup> Pub. L. No. 107-147, Sec. 414(a)(2).

<sup>20</sup> Notice 2002-29, I.R.B. 2002-16.

<sup>21</sup> *Id.*

<sup>22</sup> See Dilley and Pociask, “The Deemed Sale and Repurchase Election: Does Opportunity Knock?” 95 *Tax Notes* 223 (2002).

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