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NEW CAPITAL GAINS RULES

— by Neil E. Harl*

The new rules on taxing long-term capital gains, which became effective for sales and exchanges (and probably for payments received)[1] after May 6, 1997,[2] left many questions unanswered.[3] In anticipation of technical corrections legislation, the Internal Revenue Service has published guidance on some of the issues needing clarification.[4]

Assets held until death

The Taxpayer Relief Act of 1997[5] extended the general holding period for assets to receive long-term capital gain treatment from "more than one-year" to "more than 18 months" effective for sales and exchanges after July 28, 1997.[6] That change was not extended, however, to the code section which has provided an automatic holding period of more than one year.[7] Under that provision, gains on sales after death on eligible assets have been eligible for long-term capital gain treatment.

In 1975, IRS ruled that the provision granting an automatic "more than one year" holding period for assets held at death does not apply to livestock.[8] Therefore, livestock acquired from a decedent must have been held for 12 months or more (24 months or more for cattle and horses) for long-term capital gain treatment.[9]

The 1997 legislation did not change the automatic "more than one year" holding period for assets held until death. Therefore, it appeared that, for sales of assets after July 28, 1997, which had been held until death, it would be necessary to hold the assets for more than 18 months after death in order to be eligible for long-term capital gains treatment.[10] There was no authority for tacking on six additional months to the "more than one-year" holding period which is automatically granted.

However, in anticipation of technical corrections legislation, IRS has indicated that property held until death, if disposed of within 18 months after the decedent's death, "is now deemed to have been held for more than 18 months."[11] A similar rule applies to patents[12] and for futures contracts that are marked to market.[13]

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

Netting of gains and losses

The same IRS notice[14] also provides guidance on how gains and losses are to be netted.

First, a taxpayer's long-term capital gains and losses (including Section 1231 gains and losses) are separated into three "tax rate groups."

• The "28 percent group" (for capital loss carryovers, collectibles, transactions before May 7, 1997, of assets held for more than one year and transactions after July 28, 1997, of assets held for more than one-year but not more than 18-months;[15]

• The "25 percent group" (for "unrecaptured Section 1250" gain) which is taxed at a maximum of 25 percent;[16]

• The "20 percent" group—which also includes capital gains taxed at 10 percent.[17]

Second, short-term capital losses (including short-term capital loss carryovers) are applied first to reduce short-term capital gains with any net short-term capital loss applied to reduce net long-term capital gains from the 28 percent group, then to reduce gains from the 25 percent group and finally to reduce gains from the 20 percent group.

Third, 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 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.[18]

Unrecaptured Section 1250 gain

The gain referred to as "unrecaptured 1250 gain"[19] essentially represents the gain attributable to depreciation previously claimed on depreciable real property[20] except for gain recaptured as ordinary income. For depreciable real property which has been depreciated no faster than the straight line rate, there is generally no recapture of depreciation and all gain to the extent of depreciation claimed since 1963 is subject to the maximum rate of 25 percent.

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It appears that "unrecaptured section 1250 gain" is not subject to the rule requiring recaptured depreciation to be reported in the year of sale in the case of installment transactions.[21] Therefore, for installment sale payments received after May 6, 1997, it will be necessary to go back to the original calculations for the transaction, figure the "unrecaptured section 1250 gain," and report the portion of payments received after May 6, 1997, attributable to unrecaptured section 1250 gain at the maximum rate of 25 percent.

FOOTNOTES

1 Rep't 105-220, Taxpayer Relief Act of 1997, Conference Report Accompany H.R. 2014 at 383 (1997).
2 I.R.C. § 1(h), added by TRA-97, Sec. 311(a).
3 See Harl, "Taypayer Relief Act of 1997 (H.R. 2014): Summary of Selected Provisions," 8 *Agric. L. Dig*. 113 (1997).
4 Notice 97-59, I.R.B. 1997-45.
5 Pub. L. 105-34, 111 Stat. 788 (1997).
6 I.R.C. § 1(h), added by TRA-97, Sec. 311(a), (d).
7 I.R.C. §1223(11).
8 Rev. Rul. 75-361, 1975-2 C.B. 344.
9 I.R.C. § 1231(b)(3).
10 See I.R.C. § 1(h).
11 Notice 97-59, I.R.B. 1997-45.
12 *Id.* See I.R.C. § 1235(a).
13 I.R.C. § 1256(a)(3).
14 Notice 97-59, I.R.B. 1997-45.
15 I.R.C. § 1(h)(1)(C).
16 I.R.C. § 1(h)(1)(B).
17 I.R.C. § 1(h)(1)(D).
18 Notice 97-59, I.R.B. 1997-45.
19 I.R.C. § 1(h)(1)(B), (6).
20 See I.R.C. § 1250.
21 Treas. Reg. §§ 1.1245-6(d)(1), 1.1250-1(c)(6).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

CHAPTER 12-*ALM* § 13.03[8].*

PLAN. A third party purchased the debtors' farm by paying the county real estate taxes on the property. The debtors filed for Chapter 12 before the third party could obtain a tax deed to the property and the debtors' plan provided for payment of the taxes and interest to the third party over five years. Under state law, the third party had a lien for the amount of taxes paid. The third party objected to the plan because the party's secured status under state law would expire before the plan ended and the party would be unprotected if the debtors defaulted on the plan in the last years of the plan. The court held that the plan was not confirmable because the third party was not protected during the entire plan period. The court noted that the plan could be modified to provide protections in case of later default of the plan payments. **Matter of Woerner, 214 B.R. 208 (Bankr. D. Neb. 1997)**.

CHAPTER 13-*ALM* § 13.03.*

ELIGIBILITY. The debtor filed for Chapter 13 and listed claims for unsecured non-priority tax claims owed to the IRS. The claims were based on assessments and tax liens. The debtor identified the tax claims as disputed but did not designate the claims as unliquidated or contingent. The tax claims put the debtor's liabilities over the $250,000 limit for Chapter 13 eligibility at the time of the petition. The court found that the tax claims were liquidated and not contingent because the amount had been determined by assessment. The debtor's dispute as to the amount and propriety of the tax claims was held to be insufficient to make the claims contingent or unliqudated; therefore, the full tax claims were included in the debtor's liabilities and prevented use of Chapter 13. ***In re* Barcal, 213 B.R. 1008 (Bankr. 8th Cir. 1997)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

AVOIDABLE LIENS. The debtors had transferred all farm real and personal property to a corporation but continued to reside on the homestead portion of the property. The IRS filed a tax lien against the debtors' property for delinquent personal income taxes. The only non-exempt property held by the debtors was money and the farm corporation stock. The debtors then filed for Chapter 12 and became debtors in possession. The debtors sought to avoid the tax lien, under I.R.C. § 6323 and Section 545(2), arguing that, as debtors-in-possession, the debtors became hypothetical purchasers of the stock. In response, the IRS alleged that the lien reached all corporate assets under a claim that the corporation was the alter ego of the debtors. The court held that, because the corporation was not a party to the action, the alter ego claim could not be litigated, since the alter ego claim was not a defense to the lien avoidance claim. The court held that a debtor-in-possession was not a bona fide purchaser for purposes of I.R.C. § 6323 and the tax lien could not be avoided as to the money and stock. ***In re* Janssen, 213 B.R. 558 (Bankr. 8th Cir. 1997)**.

AVOIDABLE TRANSFERS. In 1990, the corporate debtor was assessed additional taxes for 1975. The debtor and the IRS agreed to installment payment of the taxes, interest and penalties involved. Two of the installments were paid within 90 days of the filing for bankruptcy and when the debtor was insolvent. The IRS argued that the tax payments were made in the ordinary course of business and excepted, under Section 547(c)(2), from the preferential transfer provision. The court held that the payment of delinquent taxes, interest and penalties under

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