The Time Value of Money and the Election of a Deemed Sale and Repurchase of Assets at the Beginning of 2001

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Abstract

Tax advisors need to plan now to properly evaluate a major election that can be made on the 2001 tax return and its effect on investment decisions. The election is to treat any capital asset or § 1231 assets as if it was sold and immediately repurchased at the beginning of January 2001. Even though the election is not required to be made until the 2001 return is filed, taxpayers should evaluate its effects in all decisions related to purchases and sales of capital assets and § 1231 assets. Particular attention should be paid to the effects of the timing of cash flows and evaluating the time value of money.

Summary of Capital Gain Treatment

The new capital gain and loss regimen has been part of the federal income tax for four years. Long-term capital gains can be subject to five nominal rates--10%, 15%, 20%, 25%, and 28% [IRC of 1986, § 1(h)]. Short-term capital gains can be subject to each of the five nominal rates on ordinary income—15%, 28%, 31%, 36%, 39.6% [IRC of 1986, § 1(a)]. Beginning in 2001, a new rate sneaks onto the scene—the 8% rate; and beginning in 2006—the 18% rate.

The 10% and 20% rates apply to net gains from the 20% group. The 25% rate applies 25 percent gains. The 28% rate applies to net gains from the 28 percent group [For a primer on the basics of the capital gain and loss netting process, the Capital Gains Netting Primer at http://www.pktax.com/].

- The 28 percent group consists of long-term gains and losses from sleas and exchanges of collectibles and § 1202 stock (qualified small business stock that qualifies for the 50% capital gains deduction)
- Twenty-five percent gain—or unrecaptured § 1250 depreciation—is the gain on the sale of § 1250 property held more than one-year, limited to the unrecaptured

depreciation (i.e., the excess of depreciation allowed over the amount of depreciation that was recaptured).

- The 20 percent group consists of all long-term capital gains and losses other than 25% and 28% gains and losses.

The 10% rate applies to any 20% gain that would otherwise be taxed included in the 15% tax bracket (if it was ordinary income); the 15% rate, to any 25 or 28 percent gain that would otherwise be taxed in the 15% bracket. Short-term capital gains are treated as ordinary income and both long-term and short-term losses are subject to the $3,000 annual limit [IRC of 1986, § 1211(b)].

The New Rates

The new 8% capital gains rate applies to any gain that would otherwise have been 10% gain for assets with a holding period of more than 5 years. It is effective for sales or exchanges after December 31, 2000.

The 18% rate applies to gain that would have been 20% gain to such assets that were held more than five years. It is effectively only applicable for sales or exchanges of assets after January 1, 2006, since the asset must have been acquired after December 31, 2000 [IRC of 1986, § 1(h)(2)]. However, the deemed sale and purchase requirement exists so taxpayers can qualify assets held on January 1, 2001 for this new rate, if they are held an additional five years (plus one day).

Deemed Sale and Repurchase

Any taxpayer other than a corporation, including pass-through entities, may elect to treat any capital asset or § 1231 asset held on January 1, 2001 as if it was sold and repurchased [Taxpayer Relief Act of 1997 (P. L. 105-38, 1/7/97), § 311]. For readily tradable stock, the deemed sale and repurchase occurs on January 2, 2001 at the

closing market price on that date. Any other assets that the taxpayer deems to be sold are treated as if they were sold and repurchased at their fair market value on January 1, 2001.

The Gain or Loss

The resulting gain is reported on the return for the year that includes the date of the deemed disposition. For calendar year taxpayers this is the year 2001. The gain is reported on Schedule D or Form 4797 and the basis of the property is the amount of the deemed sales price.

> Example. Debra purchased $100,000 worth of FineCorp, a readily tradable stock, in October 2000. The stock was worth $102,000 at its close on January 2, 2001 and Debra was confident that the stock would increase substantially over the following five years. Debra can elect to pretend that she sold her stock and immediately bought it back for $102,000 on January 2, 2001. If she makes this election, she has a short-term capital gain of $2,000, and if she holds the shares on January 3, 2006, they will be eligible for the new 18 percent capital gain rate.
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> If Debra, in fact, sells the FineCorp shares for $200,000 on January 2, 2006, she would recognize a gain of $98,000. Assuming that gain would otherwise be taxed at 20%, it would be taxed at 18%, saving Debra $1,960.

If a loss results, the loss is not recognized. The taxpayer simply takes a basis equal to fair market value (the deemed sales price).

> Example, Brad purchased $100,000 worth of GoodCorp, a readily tradable stock, in October 2000. The stock was worth $97,000 at its close on January 2, 2001 and Brad was confident that the stock would increase substantially over the following five years. Brad can elect to pretend that he sold his stock and immediately bought it back for $97,000 on January 2, 2001. The $3,000 loss is

not deductible, but if he holds the shares on January 3, 2006, they will be eligible for the new 18 percent capital gain rate.

If Brad, in fact, sells the GoodCorp shares for $150,000 on January 2, 2006, he would recognize a gain of $53,000. Assuming that gain would otherwise be taxed at 20%, it would be taxed at 18%, saving Brad $1,060, but Brad also lost the benefit of the original basis of $100,000 that would have applied had the election not been made, which cost him $600 ($3,000 x 20%), making the true savings only $460.

The Election

The election is to be made as prescribed by the commissioner, and once made, is irrevocable. Since any gain on the deemed sale is to be reported on the 2001 return (or fiscal year ending during 2001), speculation was that the election would be made on that return.

For fiscal year taxpayers, the 2000 forms will be used; for calendar year taxpayers, the 2001 forms. The IRS addressed the deemed sale and repurchase issue in the instructions for the 2000 Form 4797, even though they have not issued guidance through rulings or procedures. According to these instructions, the election must be made on a timely filed return (including extensions). A statement is to be attached to the return stating that an election is being made under § 311 of the ***Taxpayer Relief Act of 1997*** and specifying the assets for which the election is being made. Gains should be reported and losses should be entered as zero.

Planning Related to the Deemed Sale and Repurchase

Any time this election can be made with no tax cost or a very small tax cost, it should probably be made. There would be no tax cost if the asset was worth exactly its

adjusted basis on January 1 (or 2 for readily tradable stock), 2001. If there is very little appreciation or depreciation in value, the tax cost is small.

As the amount of appreciation or depreciation in value increases, the analysis becomes more difficult and the likelihood that the election is appropriate declines. The potential savings is only two percent and it can only be enjoyed with the more than five-year holding period.

Since the savings is only to percent the gain will need to be significant in order for the election to pay off. Furthermore, since the savings is delayed, planners must consider the time value of money.

Example. Debra, from the earlier example, reported a short-term capital gain of $2,000 in 2001 in order to save $1,960 in 2006. If Debra's short-term gain in 2001 was taxed at 31 percent, she paid additional tax of $620. But, had she not made the election, she would have owed and additional $400 in capital gains tax in 2006. This makes her net savings $1,740.

If Debra could earn an 8 percent after-tax return the present value of the $1,960 savings is $1,334. Had she not made the election she would have owed another $400 in tax, the present value of which is $272. So, in present value terms, her net savings are $987 [$1,334 – ($620 - $273)]. These results are verified by these calculations:

	With the Election	Without the Election
Sales Price	$200,000	$200,000
Adjusted basis	-102,000	-100,000
Gain	$ 98,000	$100,000
Capital Gains Tax Rate	x 18%	x 20%
Capital Gains Tax (2006)	$17,640	$20,000
Tax at Time of Election (2001)	620	0
Total Tax	$18,260	$20,000

This calculated savings of $1,740 ($20,000 - $18,260) ignores the time value of money. The present value of the two possibilities gives these results.

Present value of tax paid on 2006 gain	$12,005	$13,612
Present value of current tax	620	0
Total present value of tax payments	$12,625	$13,612

Now the savings is $987, and if the gain had been less, the savings considering the time value of money could easily have been negative.

As this example illustrates, careful analysis of the timing of the tax payments is essential. It is entirely possible that a situation that results in an overall tax savings could have a net tax cost when the time value of money is considered. The time value of money is even more significant if the property is ultimately held more than five years

Example. Rachael purchased vacant real estate as an investment for $50,000 in 1995. On January 1, 2001, it was appraised at $60,000. Rachael may elect the deemed sale and repurchase of the land, recognizing a $10,000 long-term capital gain of $10,000 and paying a tax not exceeding $2,000.

If Rachael sells the land December 31, 2010, for $120,000, she has a long-term capital gain of $60,000 and pays tax at 18%. Her savings due to the deemed sale and repurchase is 2%, or $1,200. The present value of this savings is $556 (using an 8 percent discount rate).

Had the election not been made, Rachael's gain would have been $10,000 larger, resulting in a tax increase of up to $2,000 ($10,000 x 20%). The present value of this is $926.

So, Rachael's net benefit from making the election is -$518 [$556 – ($2000 - $926)] in present value terms. In other words, she had a net tax savings that was a net tax increase when considering the time value of money. These results are verified by these calculations:

	With the Election	Without the Election
Sales Price	$120,000	$120,000
Adjusted basis	- 60,000	- 50,000

Gain	$ 60,000	$ 70,000
Capital Gains Tax Rate	x 18%	x 20%
Capital Gains Tax (2010)	$10,800	$14,000
Tax at Time of Election (2001)	2,000	0
Total Tax	$12,800	$14,000

This calculated savings of $1,200 ($14,000 - $12,800) ignores the time value of money. The present value of the two possibilities gives these results.

Present value of tax paid on 2010 gain	$ 5,003	$ 6,485
Present value of current tax	2,000	0
Total present value of tax payments	$7,003	$ 6,485

This is the same $514 difference, in favor of not making the election.

Other Planning Issues

It is also important to remind clients that the benefits are lost if they do not wait more than five years to execute the sales. There are many unanticipated intervening events could make holding the property the required time period impractical.

Taxpayers with expiring net operating losses or other large suspended losses may be able to make the election with no current tax cost. The gain triggered by the deemed sale might simply be offset by carryover losses under the capital loss limitation or some other provision of the statute.

Taxpayers with low costs of capital may receive greater benefit from future savings, whereas taxpayers with higher costs of capital find less relative value in future savings. In addition, the further into the future the savings are enjoyed, the less value, in time value of money terms, they have.

Because of these situations, generalization is difficult, and each taxpayer's situation should be evaluated individually. However, some observations can be made.

Time Value of Money

The capital gains savings related to the deemed sale and repurchase are delayed at least five years. Any savings due to the preferential rate on capital gains can only be enjoyed after five years. Any savings related to depreciation or amortization are spread over extended periods, so careful analysis of the time value of money is necessary.

As a first pass on a decision model, the following table demonstrates how much the future increase in value needs to be for the election to provide a net benefit. For this example, shares of stock are deemed to be have been held on January 2, 2000. For each assumed level of "built-in gain" on that date, the amount of appreciation that the stock would need experience over the five years (i.e., by January 3, 2006) for the taxpayer to be indifferent is calculated, using various discount rates. So, the taxpayer would only be better off if the stock sold for more than this price.

Pre-2001	Appreciation Required for Each Discount Rate (After-tax)			
Appreciation	6%	8%	10%	12%
-8%	87.0%	87.0%	87.0%	87.0%
-4	41.7	41.7	41.7	41.7
-2	20.4	20.4	20.4	20.4
-1	10.1	10.1	10.1	10.1
0	0	0	0	0
+1	3.4	4.7	6.0	7.5
+2	6.6	9.2	12.0	15.0
+4	13.0	18.1	23.5	29.3
+8	25.0	34.7	45.2	56.5
+16	46.6	64.7	84.2	105.2

An example from this table would be a stock that had cost $1,000, but had declined in value to $980 (i.e., a 2% decline) on January 2, 2001. To just break even, considering the time value of money (and any cost of capital), the stock would need to sell for $1,180 ($980 x 1.204) on January 3, 2006.

Another example, using a gain, would be stock that had cost $1,000 and had appreciated to $1,040 (i.e., a 4% increase) by January 2, 2001. To just break even, considering the time value of money (and an 8% cost of capital), the stock would need to sell for $1,228 ($1,040 x 1.181).

By studying the table, one can make a number of observations, including the following:

- The time value of money is not a factor with stock that has declined in value since all of the cash flows occur at the same time. Since the decline is not allowed as a loss deduction there is no current cash flow. However, only a small decline in value requires at least ten times that amount in appreciation for the election to pay off.
- There is no tax cost related to the election if the stock has neither appreciated nor declined in value, so there is no financial risk to making the election in such a case.
- When stock has appreciated, there is a somewhat proportional relationship between the appreciation up to January 2, 2001 [built-in gain] and the ultimate sales price (on January 3, 2006). Over the ranges presented, if the cost of capital is 6%, the gain needs to be in the neighborhood of 3 times the built-in gain; for a 12% cost of capital, in the neighborhood of 7 times.

This table allows researchers and tax planners to better explain to taxpayers what sort of appreciation will be required to warrant the deemed sale and repurchase election. The taxpayer, fortunately have more than a year's results upon which to base his or her judgment, since the election need not be made until the 2001 tax return is filed (as late as October 15, 2002 for extended calendar year returns).

Conclusion

Tax planners need to advise their clients as to the existence of the deemed sale and repurchase election and its possible advantages and disadvantages. Those with no (or very little) gain or loss should probably make the election. But, as the amount of built-in gain or loss increases, absent extenuating circumstances, the likelihood that one will benefit from the election declines rapidly.

References

Internal Revenue Code [IRC] of 1986

Taxpayer Relief Act of 1997 [P. L. 105-38, 1/7/97]