Third, the grand compromise could strengthen the IRS's litigating position if Schedule UTP is challenged in court. If the IRS does not offer a grand compromise and continues to pursue tax reserve information and tax opinions, it will be interesting to see how Schedule UTP case law develops. Given the Supreme Court's decision in *Arthur Young*,[17] the IRS still is likely to prevail, but the facts presented in a Schedule UTP case would be materially different from those in *Arthur Young*. There is a possibility that when weighing conflicting public policy goals — as the Supreme Court did in *Arthur Young* — a future court could rule against the IRS. But if the IRS offered a grand compromise perceived to be fair and reasonable, one would expect a court to be more likely to rule in the IRS's favor.

Although some will not agree, given my experience as a tax administrator and adviser I believe the grand compromise is a fair and reasonable solution to an admittedly difficult issue. Many tax directors and their advisers would prefer to disclose nothing to the IRS, but a compromise like the one described above likely would be acceptable to most. If the IRS obtains a description of all material corporate tax issues and some indication of their size, the IRS will have made a giant step forward in its efforts to audit corporate tax returns.

[17]465 U.S. 805.

The Need to Simplify the Tax Treatment of Capital Gains

By Philip J. Harmelink, William M. VanDenburgh, and James R. Hasselback

Philip J. Harmelink is the Ernst & Young Professor of Accounting at the University of New Orleans (pharmeli@uno.edu). William M. VanDenburgh is the Robinson, Farmer, Cox Faculty Fellow Assistant Professor of Accounting at James Madison University (vandenwm@jmu.edu). James R. Hasselback is the Mary Ball Washington Eminent Scholar at the University of West Florida (jhasselback@uwf.edu).

This article identifies areas of capital gains taxation in which excessive complexity has developed over time. The authors propose several alternatives for simplifying capital gains taxation with little or no revenue impact.

Over time, the taxation of capital gains (CGs) for individual taxpayers has changed greatly and its complexity has expanded significantly. Beginning on May 7, 1997, various categories of capital assets came into existence along with diverse tax treatment. Schedule D and its instructions contain the basic steps to determine a taxpayer's CGs taxation. One needs only to examine the Schedule D tax worksheet to see the nearly unworkable steps needed to determine "tax on all taxable income (including capital gains and qualified dividends)." The Schedule D instructions contain four worksheets, including:

- capital loss carryover worksheet (15 lines);
- 28 percent rate gain worksheet (7 lines);
- unrecaptured section 1250 gain worksheet (18 lines); and
- Schedule D tax worksheet (36 lines).[1]

The reality is that taxpayers and tax professionals who deal with CGs and qualified dividends often have to trust that their tax software is correctly determining the appropriate tax obligations. Meanwhile, they have difficulty with tax compliance and effective tax planning because of the inability to fully comprehend the complexity and the interaction of the various provisions. These sad but true statements are a direct result of the inability of either political party over more than a decade to even partially address escalating tax complexity. Adding to this untenable situation is the fact that many CGs provisions have to be recalculated for the alternative minimum tax.

The likelihood that the tax rate on CGs and dividends will increase should be used as a catalyst to simplify capital gains taxation. The simplification of CGs taxation is long overdue and should be an area where both

[1]IRS, "2009 Instructions for Schedule D: Capital Gains and Losses," *available at* http://www.irs.gov/pub/irs-pdf/i1040sd.pdf.

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Table 1. History of Maximum Capital Gains (CGs) and Ordinary Income (OI) Tax Rates											
Maximum	1979-1981	1982-1986	1987	1988-1990	1991-1992	1993-1997	1998-1999	2000-2001	2002	2003-2007	2008-2010
CGs	28%	20%	28%	33%	28%	28%	20% or 10%	20% or 10%	20% or 10%	15% or 5%	15% or 0%
OI	70%	50%	35.5%	33%	31%	39.6%	39.6%	39.1%	38.6%	35%	35%

political parties should be able to compromise (although the art of bipartisanship is often absent). With the coming expiration of the current tax cuts and the reversion to pre-2001 tax laws, the necessity for major tax law changes is apparent to most tax professionals. Congress and the Obama administration, however, have simply ignored the reality of this ticking time bomb.

This article examines the history of individual CGs taxation and identifies areas in which excessive complexity has grown over time. An examination of the history of CGs taxation reveals that various tax approaches have been employed. The authors conclude by proposing several possible alternatives that would simplify CGs taxation with little or no revenue impact.

History of Capital Gains Treatment

Although capital gains taxation for individual taxpayers has generally enjoyed special treatment of one form or another for 85 years, this section of the article traces the major tax treatments in effect for approximately the last 30 years. As will be seen, various rates and tax approaches have been employed, and the system has, to a degree, built superfluous complexity on itself. Table 1 summarizes the various maximum CGs and ordinary income tax rates used since 1979.

For 1979-1981, the maximum CGs rate was effectively 28 percent because taxpayers were allowed to obtain a 60 percent deduction for the excess of their net long-term CGs (net LTCGs) over their net short-term capital losses. With 40 percent of the net LTCGs being included, and with a maximum marginal ordinary income tax rate of 70 percent, the maximum CGs rate was 28 percent.

Early in the Reagan administration, when the top ordinary income rate declined to 50 percent, the 40 percent of net LTCGs included in income resulted in a maximum rate of 20 percent. This lasted until 1987, when the top maximum CGs rate rose to 28 percent while the top ordinary income rate was 38.5 percent. From 1988 to 1990, there were no special CGs rates. The maximum ordinary income rate was 28 percent. A surtax raised the maximum rate for some individual taxpayers to 33 percent.

In 1991-1992, the top ordinary income rate was 31 percent, and the top CGs rate was 28 percent, where it remained through May 6, 1997. However, at the beginning of the Clinton administration, the top ordinary income rate increased to 39.6 percent, where it remained through 1999. Meanwhile, effective May 7, 1997, the top CGs rate went down to 20 percent for those taxpayers in the 28 percent and higher tax brackets and 10 percent for those in the 15 percent and lower tax brackets; those rates remained in effect through 2001. The top marginal ordinary income rate declined minimally to 39.1 percent in 2000-2001 and to 38.6 percent in 2002. In 1997, there was a short-lived attempt to classify CGs as short-term (less than 12 months with ordinary income rates), intermediate term (less than 18 months with a 28 percent maximum rate), and long-term (more than 18 months with a 20 percent maximum rate). This provision resulted in such taxpayer outrage that it was eliminated the following year.

Additional CGs rates were established for purchases after 2000. If an asset purchased after 2000 was held longer than five years, it qualified for an 18 percent maximum CGs rate. For taxpayers in the 15 percent bracket, the maximum rate was 8 percent (instead of 10 percent) beginning in 2001 as long as the asset was held more than five years (regardless of when the asset was acquired). These provisions no longer applied when the CGs rates were lowered in 2003, but could apply in 2011.

During the Bush administration, starting on May 6, 2003, the top CGs rate went to 15 percent for taxpayers in the 28 percent or higher marginal tax brackets and to 5 percent for taxpayers in the 15 percent or lower tax brackets. Those rates remained through 2007. Meanwhile, the top marginal ordinary income rate declined to 35 percent during the 2003-2010 time period. In 2003, qualified dividends were also given the same preferential tax treatment as CGs. In 2008, the 15 percent CGs rate for taxpayers in the 28 percent or higher tax bracket was extended, and the CGs rate decreased to 0 percent for taxpayers in the 15 percent or lower tax bracket. Originally, the preferential rates on CGs and qualified dividends were due to expire in 2008.

Current and Forthcoming Taxation of Capital Gains

Long-term CGs and qualified dividends are taxed at 15 and 0 percent, respectively. However, after 2010, long-term CGs will generally be taxed at 20 percent (10 percent for taxpayers in the 15 percent tax bracket, barring any change by Congress). Dividends will be taxed at the taxpayer's ordinary income tax rate regardless of his tax bracket. The qualified five-year 18 percent CGs rate (8 percent for taxpayers in the 15 percent tax bracket) will be reinstated. When one adds the various CGs categories (many of which were created in 1997) and the tax treatment of CGs and losses, the complexity of these transactions only grows. Currently, four different preferential tax rates can apply to various categories of LT CGs (0, 15, 25, and 28 percent).

Special Treatment Starting in 1997

Starting after May 6, 1997, special CGs rate categories that were not eligible for the lowest CGs rates went into effect, greatly increasing the complexity of CGs treatment. Preferential small-business CGs and loss provisions have also been added over time.

Taxed at Potentially Different Rates

Collectibles gains. Gains on stamps, antiques, gems, and most coins are generally taxed up to the maximum rate of 28 percent. However, an exception is made for some newly minted gold and silver coins issued by the federal government and coins issued under state law.

Section 1202 gains. When a taxpayer sells certain small-business stock (section 1202 stock) that has been held for more than five years, 50 percent of the gain is excluded from gross income. The remaining gain from the sale of this stock is taxed at a maximum rate of 28 percent. As can be expected, this provision has numerous restrictions (for example, the issuing company must have assets less than $50 million, $10 million in gain or 10 times the basis limitation, and nonapplicability for certain businesses, etc.). The percentage exclusion is increased to 75 percent for stock acquired after February 11, 2009, and before January 1, 2011.

Section 1231 gains. Section 1231 applies to business assets that are sold. When netting section 1231 gains and losses, if the netting is positive, the gain is treated as a capital gain (after the sections 1245 and 1250 recapture rules have been applied). If the netting is negative, the loss is ordinary.

Section 1244 losses. When a taxpayer sells a small-business stock at a loss, the capital loss limitations do not apply for a portion of the loss. Individuals can deduct up to $50,000 of the loss as ordinary ($100,000 if married filing jointly) on an annual basis. Here, the issuing company must have less than $1 million in total capitalization (as opposed to a $50 million asset ceiling for section 1202), as well as comply with other restrictions.

Section 1245 gains. When tangible personal property (for example, a business asset) is sold at a gain, all prior allowable depreciation, whether taken or not, is subject to ordinary income recapture.

Section 1250 gains. Complicated ordinary income recapture rules apply for section 1250 assets (real property), especially if purchased before 1987 when accelerated depreciation was allowed.

Unrecaptured section 1250 gains. Under section 1250, real estate gains are taxed at a maximum rate of 25 percent for individual taxpayers. The maximum amount taxed at 25 percent is the total depreciation taken on the property not to exceed the recognized gain. This maximum amount is reduced by the amount that was treated as ordinary income under section 1250 depreciation recapture rules. That ordinary income portion would be limited by the total amount of recognized gain.

These provisions and their interplay can result in many perplexing tax consequences when a long-term asset is sold. Even more disconcerting is that section 1231 gains treatment for business assets often do not even occur because of section 1245 depreciation recapture (section 1245 assets generally are sold at little or no gain). The complicated section 1250 recapture provisions apply only if the building was acquired before 1987. The following three examples describe various outcomes based on selling a nonresidential building property in 2010 and the complex tax calculations that can be involved.

Example 1: Assume the taxpayer bought a nonresidential building in 1975 for $800,000 with an estimated life of 40 years, used the 150 percent declining balance method of depreciation, and sold it in early 2010 for $1 million. The depreciation taken in 1975 was $30,000, straight-line depreciation was $20,000, and the depreciation for 1976 through 2009 was $679,926, for a total depreciation of $709,926 and total straight-line depreciation of $700,000. Thus, the taxpayer would have two tax bases ($90,074 under the modified accelerated cost recovery system and $100,000 for straight-line). Therefore, the excess depreciation for the total time period was $9,926, and that would be recaptured as ordinary income. The remaining depreciation of $700,000 would be taxed at a maximum rate of 25 percent, and the remaining gain of $190,074 would be section 1231 gain that would be eligible for the lowest maximum CGs rate (currently 15 percent).

Example 2: If the above taxpayer sold the building for only $95,000, all the recognized gain of $4,926 would be recognized as ordinary income and there would be no gain taxed in the 25 percent or 15 percent categories. However, if the building was sold for only $80,000, there would be a recognized loss of $10,074, which would be a section 1231 loss, and nothing would be recaptured as ordinary income or as unrecaptured section 1250 gain. The taxpayer would have an ordinary loss if this were the only section 1231 transaction for the year. Multiple section 1231 transactions complicate the calculations with the required nettings.

Example 3: If a taxpayer purchased a nonresidential building in 1983 (accelerated cost recovery system time period) for $800,000 and fully depreciated it under an accelerated method, and then sold it in 2010 for $1 million, there would be a recognized gain of $1 million. There is $800,000 recaptured as ordinary income (because accelerated depreciation was used), and the remaining $200,000 is section 1231 gain, which is eligible for potential 15 percent maximum taxation. However, if straight-line depreciation was used, the gain would consist of $800,000 taxed at the 25 percent maximum bracket, and $200,000, which would be eligible for 15 percent maximum taxation. Similar to the nonresidential building computation, if the property was a residential rental building, it would get the same treatment of $800,000 taxed at a 25 percent maximum rate, and $200,000 at a 15 percent rate regardless of whether the building was depreciated under an accelerated method or under the straight-line method.

These examples show how quickly CGs tax compliance and tax planning can become difficult. The interplay of these various code sections (sections 1221, 1231, 1245, 1250, and others) stretch the workability of the U.S. tax system for little or no real purpose, both from a tax administration perspective and a tax compliance perspective.

Tracking the Baskets

In addition to various potential CGs tax rates, there are different types of property that result in the need to keep track of baskets or categories:

- **Short-term basket.** This is a combination of all short-term CGs and losses and short-term capital loss carryovers.
- **28 percent basket.** This is calculated by adding all the collectibles gains and losses, section 1202 gains, and long-term capital loss carryovers.
- **25 percent basket.** This is the total of unrecaptured section 1250 gains, which could be up to the total

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Table 2

	Short-Term Capital Loss	Short-Term Capital Gain	28% Gain	25% Gain	15% Gain
Situation 1	($24,000)	$10,000	$6,000	$4,000	$2,000
Situation 2	$0	$10,000	$6,000	$4,000	$2,000
Situation 3	($24,000)	$10,000	$6,000	$4,000	$10,000

depreciation taken on the sale of section 1250 assets but not to exceed the recognized gain that exceeds the amount of the gain recaptured at the taxpayer's ordinary rate.

- **15 percent basket.** This contains long-term CGs and losses not included in the other baskets.

Further nettings have to be considered if there are net losses. A net loss from the 28 percent basket is used to reduce gains from the 25 percent basket and then to reduce net gains from the 15 percent basket. A net loss from the 15 percent basket is used to reduce gains from the 28 percent basket and then to reduce gains from the 25 percent basket. Net short-term capital losses are used to reduce gains from the 28 percent basket and then to reduce gains from the 25 percent basket, and then to reduce net gains from the 15 percent basket.

Net short-term CGs are used to reduce any net losses in the 28 percent basket and then the 15 percent basket. Any net capital gain that remains in a particular basket is taxed at that basket's marginal tax rate. Any excess loss that remains is deductible, up to $3,000 for married couples filing jointly and single taxpayers (or $1,500 for married taxpayers filing separately).

Example 4: Assume a single 35 percent marginal tax bracket taxpayer, a $350,000 salary, and the following CGs and losses faces the three situations in Table 2.

In Situation 1, the taxpayer has a net short-term capital loss of $14,000, which is used to offset the $6,000 28 percent gain, the $4,000 25 percent gain, and the $2,000 15 percent gain to leave a $2,000 loss that is deductible by the taxpayer. In Situation 2, the taxpayer has four gains: a net short-term capital gain of $10,000 that is taxed at the 35 percent marginal tax rate, a gain of $6,000 that is taxed at the 28 percent marginal tax rate, a $4,000 gain that is taxed at the 25 percent marginal tax rate, and a $2,000 gain that is taxed at the 15 percent marginal tax rate. In Situation 3, the taxpayer has the net short-term capital loss of $14,000, which is used to offset the $6,000 28 percent gain, the $4,000 25 percent gain, and $4,000 of the 15 percent gain, thereby leaving $6,000 of the 15 percent basket to be taxed at a 15 percent marginal tax rate.

Example 4 shows the complexity and the diverse outcomes that occur when calculating the tax results for the tax baskets. There are an almost infinite number of possibilities when applying the netting rules, depending on a taxpayer's gains and losses. Complying with the excessively complicated tax rules that now apply to the capital transaction provisions requires real diligence, along with luck, when a taxpayer has multiple tax baskets in which to group the capital gains and losses.

These complications make it extremely difficult for taxpayers to understand, much less comply with, the various CGs code sections. The Schedule D worksheet is virtually impossible for the average taxpayer and even tax return preparers to understand. Ford, Hulse, and Pope's *Tax Notes* article on the taxation of collectibles demonstrates that the misunderstandings in their taxation is likely "an unintended consequence of a complicated system of taxing long-term capital gains."[2] Even though most taxpayers and nearly all tax return preparers now use some type of computerized tax calculation service, taxpayers do not understand what is really occurring, and this complication makes it difficult for them to do proper tax planning.

Other Complications

While preferential CGs rates apply for AMT purposes, several of the gain or loss provisions must be reconfigured. For a section 1202 gain, 7 percent of the gain is added back to taxpayers' AMT income.[3] For section 1245 property, there are two tax bases (one for AMT and one for regular tax basis). Over the life of the property, the same amount of depreciation is taken under both approaches, but the annual amount varies. Initially, this results in an increase to AMT income, but then the situation reverses. If the property is sold before being fully depreciated, yet another AMT adjustment is required. Example 5 shows the complexity created for tax planning and compliance.

Example 5: Assume a taxpayer purchases business property with MACRS five-year class life for $100,000 in 2008 and sells it in 2009 for $68,000. Assuming the half-year convention applies, the taxpayer's depreciation deduction for regular tax purposes (assuming no bonus depreciation or section 179 election) for years 2008 and 2009 is $20,000 and $16,000, respectively. For AMT purposes, the depreciation is limited in 2008 and 2009 to $15,000 and $12,750. The taxpayer has two different tax bases for the asset sold. For regular tax purposes, his basis is $64,000, and for AMT purposes it is $72,250. Thus, for regular tax purposes, the sale results in an ordinary income of $4,000, and for AMT purposes there is a section 1231 loss of $4,250.

Unfortunately, the trend for more specialized CGs categories has political appeal. For example, President Obama's fiscal 2011 budget proposed a new 0 percent CGs tax rate for "qualified small-business stock" acquired after February 17, 2009.[4]

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[2]Allen Ford, David S. Hulse, and Thomas R. Pope, "What's the Tax Rate on Collectibles Gain?" *Tax Notes*, Mar. 1, 2010, p. 1067, *Doc 2010-1824*, *2010 TNT 40-6*.

[3]IRS, "2009 Instructions for Form 6251: Alternative Minimum Tax — Individuals," *available at* http://www.irs.gov/pub/irs-pdf/i6251.pdf, p. 4.

[4]"Federal Tax Alert: President's FY 2011 Budget's Tax Proposal, Part I," *RIA Tax Alerts Developments*, Feb. 8, 2010.

Exhibit 1. JCT's 2007 Projections on AMT Adjustments				
Percentage of Total AMT Preferences and Adjustments Projections for Selected Years				
AMT Preferences and Adjustments	**2006**	**2007**	**2010**	**2017**
State and local tax deduction	62.7%	44.1%	44.4%	39.3%
Personal exemptions	22.4%	42.7%	44.4%	47.5%
Miscellaneous itemized expenses deduction	11.4%	7.3%	6.8%	6.9%
Standard deduction	1.2%	6.3%	5.2%	6.8%
Medical expense deduction	0.5%	0.7%	0.9%	1.2%
Refund of taxes	-3.5%	-2.6%	-2.6%	-2.4%
All other preferences and adjustments	5.3%	1.6%	0.8%	0.7%
Total	**94.7%**	**98.4%**	**99.2%**	**99.3%**

Recommendations

The above discussion shows that the whole area of CGs and losses is excessively complicated and should be revised. One could argue that it would be more straightforward to return to a system similar to what was in place before 1998. Various alternatives are possible, all of which would be easier and less cumbersome than the present system. One solution would be to eliminate a portion of CGs from taxation and tax the rest at ordinary rates (the system in place before 1987). Another would be to increase the top CGs tax rate along with eliminating the various categories of CGs while possibly retaining a 0 percent CGs tax rate for lower-income taxpayers. Other actions to consider would include completely eliminating special treatment for CGs, eliminating depreciation recapture, increasing the capital loss deduction, and eliminating AMT adjustments for depreciation.

Alternatives to Simplify Capital Gains Taxation

Alternative 1: One solution to reduce complexity would be to eliminate the 28 and 25 percent baskets and have CGs taxation revert to a system that allows a 60 percent deduction for net LTCGs, with the remaining 40 percent taxed at the taxpayer's marginal tax bracket. Under the current tax rate structure, with a maximum ordinary rate of 35 percent, this would mean the maximum CGs tax rate would be 14 percent (40 percent of 35 percent). A 50 percent deduction and an inclusion of 50 percent would mean the maximum tax rate would be 17.5 percent (50 percent of 35 percent). If the predictions for changes for the future were to actually include increases in marginal tax rates, and if the top ordinary marginal rate were 40 percent, that would be a maximum CGs tax rate of 16 percent (40 percent of 40 percent) with a 60 percent deduction, and a 20 percent maximum CGs rate (50 percent of 40 percent) with a 50 percent deduction.

Alternative 2: Another solution would be to eliminate the 28 and 25 percent baskets and impose a CGs rate up to a specific tax rate on the net CGs (possibly 20 percent, which has been discussed recently). That is, taxpayers in the 15 percent ordinary income tax bracket would be taxed up to the amount of 15 percent, and taxpayers in higher brackets would be taxed at the maximum rate of 20 percent on net CGs. However, if it were deemed that taxpayers in the 15 percent bracket should also have a special concession, we could revert to the taxation of net CGs at 5 or 0 percent. A 0 percent bracket would mean small businesses would receive capital gains taxation relief without the complexity of creating and complying with a new code section as proposed in the fiscal 2011 budget.

Alternative 3: The preference that CGs taxation provides could be eliminated (which would be simplicity at its core). While this essentially occurred in 1988-1990, this alternative would likely meet strenuous political objections from both political parties. Strong economic arguments for preferential treatment of CGs can be made as well.

Other Recommendations

In the area of capital losses, the $3,000-per-year restriction should be increased. This would ease data requirements for both the IRS and taxpayers. While some have advocated indexing this amount, in general, indexing this loss figure does not facilitate simplification. However, an increased loss limitation to around $10,000 per year is long overdue given the economic situation and the recent volatility in the stock market. Eliminating the depreciation recapture provisions should be seriously considered, as this would increase simplification (for section 1245 property and especially for section 1250 property purchased before 1987).

In the AMT area, different depreciation methods and the recalculation of gains or losses on the sale of section 1231 assets result in excess record-keeping requirements for taxpayers and require a set of at least two different long-term asset bases (this could last as long as 40 years for some section 1250 assets purchased pre-1987). The disconcerting nature of the complexity and cross purposes that have occurred in the code is that the interplay of the various provisions between AMT and regular tax can often result in little net revenue gain for the government. In a 2007 Joint Committee on Taxation report, the AMT preferences and adjustments required for potential CGs issues (sections 1231, 1202, and passive activities) were expected to be less than 1 percent of all AMT preferences and adjustments in 2010 and 2017 (see the "all other preferences and adjustments" in Exhibit 1).[5] In other words, different AMT calculations serve little or no long-term purpose to the U.S. government's revenue

[5]JCT, "Present Law and Background Relating to the Individual Alternative Minimum Tax," JCX-10-7, Mar. 2007, *Doc 2007-5732*, *2007 TNT 44-16*.

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stream, but they do cause very real costs in terms of compliance — or, conversely, noncompliance — as well as ambiguity and confusion regarding tax planning issues. Therefore, requirements for these AMT adjustments should be eliminated.

Conclusion

As this article demonstrates, the taxation of CGs quickly becomes very complicated. Eliminating various categories with potential CGs treatment and different tax rates would simplify what has become a mostly impractical compliance situation for taxpayers with CGs and capital losses. Adding to this madness is that many depreciation and CGs calculations often have to be reconfigured for AMT tax purposes. The reality is that tax software is used to calculate the results of CGs transactions, and taxpayers and tax practitioners are often forced to blindly rely on the results.

We believe that our proposed alternatives 1 or 2 are very workable and would greatly simplify the tax system. Further, this would be an appropriate time to eliminate depreciation recapture provisions, increase the capital loss deduction to $10,000, and eliminate AMT depreciation adjustments. With the virtual certainty of higher CGs rates in 2011 through reversion to earlier tax treatment if no legislation occurs, Congress and the administration now have an excellent opportunity for significant and long overdue simplification in the CGs area. Of course, this outcome would require political compromise by both parties, which has proven to be difficult.

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