

Tax Planning for Federal Appointee's Conflict of Interest Requirements

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Introduction

Over the next several months, many individuals will accept appointments to important positions within the federal government. To join the new administration, most will be required to divest themselves of property to comply with conflict of interest requirements under the Ethics in Government Act.¹

This article examines the special rule of section 1043 that permits such individuals to defer the recognition of gain from those sales if the individual later purchases government securities or diversified mutual funds in an amount equal to the sale proceeds. Although this deferral rule is designed for a relatively limited number of public officials, the tax benefits under section 1043 available to those officials are considerable. In any event, an election under section 1043 calls for scrupulous compliance given the high profile of those individuals and the public embarrassment should they fail to adhere to a technical provision.²

Deferral of Gain

In general, an eligible person who sells any property under a certificate of divestiture may defer recognition of gain from that sale if certain permitted property is

purchased by the individual within 60 days of the sale.³ Gain is recognized only to the extent the amount realized on the sale exceeds the cost of any permitted property purchased by the individual during the 60-day period following the sale of the property listed in the certificate of divestiture.⁴

If the cost of the permitted property exceeds the basis of the divested property so that some or all of the gain is deferred, the amount of gain deferred is reported on the individual's return.⁵

Example 1: An eligible person sells stock in a corporation for \$100,000 under a certificate of divestiture when the person has a basis in the stock of \$10,000. Within 60 days of the sale, the individual buys permitted property for \$100,000. The individual does not recognize the \$90,000 gain on the sale.

Example 2: On December 15, 2008, an eligible person sells stock (basis \$10,000) under a certificate of divestiture for \$100,000 resulting in a realized gain of \$90,000. Ten days later the individual buys permitted property for \$75,000. The individual defers gain on \$65,000, that is, \$75,000 less the person's basis of \$10,000 in the stock, and recognizes \$25,000 of the \$90,000 gain.

Example 3: Same as Example 2 except that on January 15, 2009, the eligible person buys an additional \$25,000 of permitted property. None of the \$90,000 gain is recognized.

If the property sold consists of stock options and the proceeds are not fully reinvested in permitted property, a special rule provides that the sale of the stock when the option is exercised meets any holding period requirement to treat the recognized portion of the gain as long-term capital gain.⁶

Finally, if the eligible person sold depreciated property such that a portion or all of the gain is subject to recapture, the ordinary income arising from the recapture

³Section 1043(a). Also, regulations under the Ethics in Government Act of 1978 that authorize the Office of Government Ethics to issue a certificate of divestiture provides:

Reinvestment of proceeds. To qualify for deferral of capital gains, an eligible person must reinvest the proceeds from the sale of the property divested pursuant to a Certificate of Divestiture into permitted property during the 60-day period beginning on the date of the sale. The proceeds may be reinvested into one or more types of permitted property.

⁵ 5 C.F.R. section 2634.1006(a).

⁴If gain is recognized, the taxable portion of the sale is reported on the eligible person's Schedule D or Form 4797.

⁶The deferred gain is reported on Part IV, "Deferral of Gain From Section 1043 Conflict-of-Interest Sales" of Form 8824, "Like-Kind Exchanges." See Exhibit A.

⁶Section 421(d).

¹Ethics in Government Act of 1978, P.L. No. 95-521. This act established the Office of Government Ethics to provide direction on policies concerned with preventing conflicts of interest by employees of the executive branch of the federal government.

²This article will not discuss other alternatives available to public officials to avoid conflicts of interest, most notably blind trusts. For a discussion of the qualified blind trust established under the Ethics in Government Act of 1978, see Bellard, "The Short-sightedness of Blind Trusts," 56 *Kan. L. Rev.* 43 (2007).

TAX PRACTICE

rules cannot be deferred under section 1043 and is taxable regardless of the amount of permitted property purchased.⁷

Eligible Persons

Three types of individuals qualify under section 1043 for the deferral of gain on the sale of property under a certificate of divestiture. Officers or employees of the executive branch or a judicial officer of the federal government, other than individuals employed on a temporary or part-time basis, may elect section 1043.⁸ Judicial officers for this purpose include judges in the following courts:

- Supreme Court;
- U.S. courts of appeal, including the Court of Appeals for the Federal Circuit;
- U.S. district courts, including courts in Guam, the Northern Mariana Islands, and the Virgin Islands;
- Court of International Trade;
- Tax Court;
- Court of Federal Claims;
- Court of Appeals for Veterans Claims;
- U.S. Court of Appeals for the Armed Forces; and
- any other court created by Congress, judges of which are entitled to hold office during good behavior.⁹

Another individual qualifying for deferral of gain under section 1043 is any spouse or dependent child whose ownership of any property is attributable to an executive branch officer, employee, or judicial officer subject to a conflict of interest statute, regulation, rule, judicial canon, or executive order for which a certificate of divestiture could be issued.¹⁰

Finally, a trustee of a trust, with respect to property held in the trust, may take advantage of section 1043 if an executive branch employee, officer, or judicial officer has a beneficial interest in the trust's principal or income.¹¹ This category also applies to a trustee of a trust, with respect to property held in the trust, if a spouse or dependent child of the executive branch employee or judicial officer has a beneficial interest in the trust's principal or income, and the beneficial interest is attributable under a conflict of interest statute, regulation rule, judicial canon, or executive order to the executive branch employee or judicial officer.¹²

Certificate of Divestiture

As discussed previously, the nonrecognition rule applies only to property sold under a certificate of divesti-

ture issued by the Office of Government Ethics.¹³ To meet this requirement, the document issued to the eligible individual must:

- be a written determination;¹⁴
- state that divestiture of specific property is reasonably necessary to comply with any federal conflict of interest statute, regulation, rule, judicial canon, or executive order, or be requested by a congressional committee as a condition of confirmation;¹⁵
- be issued by the president or the director of the Office of Government Ethics in the case of executive branch employees, or by the Judicial Conference of the United States (or its designee) in the case of judicial officers;¹⁶ and
- identify the specific property to be sold.¹⁷

In general, the eligible individual does not apply for the certificate of divestiture; rather, the agency or court by which the individual is to be employed requests the document. To comply with federal ethics rules, the request for the certificate must provide details as to why divestiture is necessary and a statement by the eligible person that she will divest the property if the certificate is issued.¹⁸ A certificate of divestiture will not be issued retroactively for sales before the request of the certificate.

Example 4: During her Senate confirmation hearing, a nominee to a Department of Defense (DOD) position is directed to divest stock in a DOD contractor as a condition of her confirmation. Eager to comply with the order, the nominee sells her stock immediately after the hearing and before being confirmed by the Senate. Once she is a DOD employee, she requests a certificate of divestiture for the stock. Because the Office of Government Ethics cannot issue a certificate of divestiture for property that has already been divested, the employee's request for a certificate of divestiture will be denied.¹⁹

Permitted Property

For gains to be deferred, the proceeds from the sales made under the certificate of divestiture must be reinvested by means of a purchase of permitted property

¹³See Exhibit B for a prototype certificate of divestiture. The certificate number on the document is noted on Part IV of Form 8824 to indicate the eligible person may use section 1043, but the certificate itself is not attached to the return.

¹⁴Section 1043(b)(2).

¹⁵Section 1043(b)(2)(A) refers to 18 U.S.C. section 208, which provides that no government employee can participate in any matter in which he has a financial interest unless that interest is disclosed and found insubstantial by the employee's supervisor or unless the director of the Office of Government Ethics finds the interest too remote or inconsequential to affect the employee's integrity.

¹⁶Section 1043(b)(2)(B). The Judicial Conference of the United States consists of the chief justice of the U.S. Supreme Court, the chief judge of each U.S. circuit court of appeals, the chief judge of the Court of International Trade, and a district judge from each judicial circuit.

¹⁷Section 1043(b)(2)(C). (See Exhibit B for a sample certificate of divestiture.)

¹⁸See Exhibit C, Request for a Certificate of Divestiture issued by the U.S. Office of Government Ethics.

¹⁹5 C.F.R. section 2634.1004, Example 3.

⁷Sections 1245(d) and 1250(h) provide that the recapture rules are to apply notwithstanding any other provision of subtitle A including section 1043.

⁸Section 1043(b)(1)(A) references 18 U.S.C. section 202, which provides that individuals employed for no more than 130 days out of any 365-day period are special employees not able to elect section 1043.

⁹Section 1043(b)(6). Note that members of Congress and other employees of the legislative branch are not eligible persons under section 1043.

¹⁰Section 1043(b)(1)(B).

¹¹Section 1043(b)(5)(A).

¹²Section 1043(b)(5)(B).

within 60 days of the sale. For this purpose, permitted property is any obligation of the United States or any diversified investment fund approved by regulations of the Office of Government Ethics.²⁰ The eligible person will be considered to have purchased property only if his unadjusted basis in the property would be its cost within the meaning of section 1012 before any adjustment is made to that basis for the nonrecognition rule of section 1043.²¹

Although there is no formal preapproval process for rolling over the sales proceeds to permissible government securities or diversified mutual funds, regulations provide that the director of the Office of Government Ethics may declare that ownership of a financial interest is too remote or too inconsequential to affect the integrity of the services of a public official such that no sale is required.²²

While regulations do not define what constitutes "an obligation of the United States" that is permitted property, they do clarify what constitutes a diversified mutual fund. Generally, a mutual fund for this purpose means any entity registered as a management company under the Investment Company Act of 1940. These funds include open-ended or closed mutual funds, registered money market funds, and any unit investment trust that is a regulated investment company under section 851.²³

A mutual fund that meets the above definition is diversified if it does not have a stated policy of concentrating its investments in any industry, business, single country other than the United States, or bonds of a single state within the United States.²⁴ In the case of any employee benefit plan or pension, there must be a written policy or written statement by the plan manager stating that the plan assets are varied. Generally, whether a

mutual fund meets this standard may be determined by checking the fund's prospectus or by calling a broker or manager of the fund.²⁵

In meeting the 60-day rollover requirement for permitted property, the law does not adopt any tracing principle whereby the specific proceeds of the sale must be used to purchase the replacement property. The statute only requires that the permitted property be purchased within the 60-day period beginning on the date of sale without regard to the funding source used to acquire the property.

The holding period of the permitted property purchased within the 60-day period includes the holding period of the property sold as of the date of sale.²⁶

Example 5: Property purchased on January 1, 2009, is sold under a certificate of divestiture on November 1, 2009, and permitted property is purchased on January 1, 2010. The eligible person's holding period in the permitted property is 11 months on January 1, 2010.

Finally, the cost basis in the permitted property is reduced by the unrecognized gain from the sale made under the certificate of divestiture. Therefore, any gain from the sale of property under the certificate of divestiture is deferred until the permitted property is sold.²⁷

Example 6: An eligible person sells stock with a basis of \$10,000 for \$30,000 under a certificate of divestiture. If within 60 days of the sale the eligible person buys permitted property for \$30,000, the basis of that property is reduced by the unrecognized gain of \$20,000. Consequently, when the permitted property is sold, the deferred gain of \$20,000 will be recognized.

Conclusion

Because many federal government appointees will undergo extraordinary scrutiny of their financial affairs, including their tax returns, the proper treatment and reporting of sales required to avoid conflicts of interest is imperative. The election to defer gain on such sales available to these officials will not only result in tax savings but also avoid embarrassing disclosures that might interfere with their appointment and the execution of their official duties. Therefore, obtaining professional tax advice is essential for any individual considering such an appointment.

²⁰Section 1043(b)(3).

²¹Section 1043(b)(4).

²²18 U.S.C. section 208(b) and 5 C.F.R. section 2640.101. Thus, for example, diversification of a mutual fund is waived in the case of investments of less than \$50,000 in a sector mutual fund.

²³For purposes of the Ethics in Government Act of 1978 and the requirements of the certificate of divestiture issued by the Office of Government Ethics, permitted property means an obligation of the United States or a diversified investment fund that is either a diversified mutual fund or diversified unit investment trust such as a real estate investment trust. 5 C.F.R. section 2634.1003.

²⁴5 C.F.R. section 2640.102(a).

²⁵*Id.* If an eligible person later invests cash into a new mutual fund, the investment must be reported to the Office of Government Ethics on a financial disclosure form (SF 278). If the investment was found not to be sufficiently diverse, the ethics officer of the agency or court employing the eligible person would inform the individual.

²⁶Section 1223(14).

²⁷Section 1043(c).

Exhibit A, Part IV (Deferral of Gain from Section 1043 Conflict-of-Interest Sales) Of Form 8824 (Like-Kind Exchanges)

Part IV Deferral of Gain From Section 1043 Conflict-of-Interest Sales

Note: This part is to be used only by officers or employees of the executive branch of the Federal Government or judicial officers of the Federal Government for reporting nonrecognition of gain under section 1043 on the sale of property to comply with the conflict-of-interest requirements. This part can be used only if the cost of the replacement property is more than the basis of the divested property.

26 Enter the number from the upper right corner of your certificate of divestiture. (Do not attach a copy of your certificate. Keep the certificate with your records.) ▶ _____

27 Description of divested property ▶ _____

28 Description of replacement property ▶ _____

29 Date divested property was sold (month, day, year) 29 / /

30 Sales price of divested property (see instructions)	30				
31 Basis of divested property	31				
32 Realized gain. Subtract line 31 from line 30				32	
33 Cost of replacement property purchased within 60 days after date of sale	33				
34 Subtract line 33 from line 30. If zero or less, enter -0-				34	
35 Ordinary income under recapture rules. Enter here and on Form 4797, line 10 (see instructions)				35	
36 Subtract line 35 from line 34. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797 (see instructions)				36	
37 Deferred gain. Subtract the sum of lines 35 and 36 from line 32				37	
38 Basis of replacement property. Subtract line 37 from line 33				38	

Form 8824 (2007)

Exhibit B. Certificate of Divestiture



United States
Office of Government Ethics
 1201 New York Avenue, NW., Suite 500
 Washington, DC 20005-3917

CERTIFICATE OF DIVESTITURECertificate No. OGE-2007-

ELIGIBLE PERSON:

DATE OF ISSUANCE:

DIVESTITURE PROPERTY:

shares,

Inc.

This Certificate of Divestiture is issued in accordance with section 1043 of the Internal Revenue Code of 1986 and 5 C.F.R. § 2634.1002 with respect to the specific property described above. I hereby determine that the divestiture of the described property is reasonably necessary to comply with 18 U.S.C. § 208, or other applicable Federal conflict of interest statutes, regulations, rules, or executive orders.

 Director

cc:

OGE - 105
 August 1992

Exhibit C. Request for Certificate of Divestiture

REQUEST FOR A CERTIFICATE OF DIVESTITURE
(to be completed by the agency, not by the requesting employee)

requesting employee and position title:	employing agency and component:
agency point of contact:	telephone number for agency point of contact:
signature of Designated Agency Ethics Official:	date:

For complete instructions on requesting a Certificate of Divestiture, please review 5 C.F.R. part 2634, subpart J.

1. Provide the requested information about the property being divested and the owner(s) of that property. Indicate whether each property owner is one of the following: (a) a government employee; (b) a spouse, a minor child or a dependent child of a government employee; or (c) a trustee of a trust for the benefit of an eligible person. For stock, provide the number of shares of stock owned. For a partnership, provide the percentage of the partnership owned.

description of the property	quantity or percentage owned	owner(s) of the property	relationship to the employee
McDonald's Corp. Play Toys, LP	57 shares 12.24% interest	John A. Jones	self
General Electric, Co.	251 shares	John A. Jones (joint) Mary B. Jones	self spouse
The Home Depot, Inc.	165 shares	Mary B. Jones	spouse
Merck & Co., Inc.	33 shares	William C. Smith	trustee
Coca-Cola, Co.	55 shares	John A. Jones (as custodian) Robert D. Jones	self dependent child

description of the property	quantity or percentage owned	owner(s) of the property	relationship to the employee

If you need additional space to accommodate your responses please click here for a continuation page

2. Provide a brief description of the employee's position or provide a citation to a statute that establishes the duties of the position. **(Please click here for a continuation page for response if needed.)**

Exhibit C. Continued

3. Provide a detailed explanation of the basis for your conclusion that divestiture is reasonably necessary to comply with Federal ethics rules (including an indication as to the date on which the requirement to divest first applied). **(Please click here for a continuation page for response if needed.)**

4. Indicate how the property was acquired (e.g., purchase prior to appointment, inheritance after appointment, gift prior to appointment, etc.). If various items of property were acquired in different ways, be specific about how the various items were acquired (e.g., "Except for the Microsoft stock, the employee purchased all of the property before beginning government service in July 2001. The employee's spouse inherited the Microsoft Stock earlier this month on September 3, 2007."). **(Please click here for a continuation page for response if needed.)**

5. Please address all items below:

a. Have you enclosed a written request from the employee that contains an unconditional statement that the property owner(s) will divest the property? No Yes

b. Have you enclosed the employee's most recent financial disclosure report or the equivalent? No Yes

c. Is any other financial interest of the employee "similar or related" to the property being divested? No Yes

d. Is any of the property held in a tax-deferred retirement plan? *Indicate which property is held in the plan in your response to Item 6.* No Yes

e. Was any of the property acquired through an employee benefit plan (e.g., stock options, restricted stock, etc.)? *Indicate which property was acquired in this manner and the type of employee benefit plan in your response to Item 6.* No Yes

f. If any of the property is held in a trust, have you enclosed the trust agreement? N/A No Yes
Indicate which property is held in a trust in your response to Item 6.

6. Provide any additional information that you would like OGE to consider when processing the request. (Use this space to address the timing of the request, if it is submitted after the deadline for divestiture.) **(Please click here for a continuation page for response if needed.)**

7. Print this document and submit the signed original with all enclosures to the following address:
Director, U.S. Office of Government Ethics, 1201 New York Avenue, NW, Suite 500, Washington, DC 20005-3917.

Print

Reset

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