InvestmentNews
The Leading Information Source for Financial Advisers

# Holding periods are a moving target

*Minimum time required to hold an investment and qualify for preferential tax treatment has varied*

September 22, 2013 - 12:01 am EST

There are many instances in which the government demands a minimum holding period for an investment to obtain a long-term capital gains tax rate in order, I assume, to prove that the investment wasn't a speculation or merely a tax savings transaction.

Most investors are aware that in order for an individual taxpayer to get favorable tax treatment on a qualifying dividend, the dividend recipient must have held the shares for a minimum of 61 days.

The minimum-holding-period rules on dividends go way back. Corporations have always received a tax break on dividends that they get from another corporation in recognition of possible cascading levels of tax on the same income.

Originally, such corporations had to hold shares only over the record date to get the tax break. The government threw sand in the gears, creating a 16-day minimum holding period.

In 1984, when companies were perceived to be “dividend stripping,” the rules were changed again, lengthening the minimum holding to 46 days. This is still the minimum time for a corporate dividend recipient.

When the Bush administration granted a dividend tax break to individuals, Congress implemented a 61-day minimum, thinking that 46 days represented too brief a time for all taxpayers. Ironically, if one shorts a stock and pays out a dividend expense, that payment is allowed as an interest deduction only if it is short at least 46 days.

That is right: 61 days for dividends gotten and 46 days for dividends paid out.

Other situations demanding minimum holding periods are exchange funds (seven years), specialized small-business investment companies (five years), extraordinary dividends (two years), incentive stock options (two years from grant) and tax-free income from a fund (six months).

The rules for taxpayers who receive long-term-gain distributions from mutual funds or real estate investment trusts require a six-month holding period — while curing a constructive sale requires 61 days, wash sales 31 days and foreign-dividend tax credits 16 days. These holding period rules are a work in progress.

In 1867, all gains were defined to be included in the taxable-income base. An 1872 court case reversed that by deciding that all gains are to be free of tax.

This lasted until 1913 when gains went back into the tax base.

In 1921, long-term gains were first given preferential tax treatment. The minimum holding period for this tax break was two years.

In 1934, things got complicated with a graduated system sliding scale of five different possibilities: 100% taxed as income if held for less than 12 months, 80% taxed if held for one to two years, 60% taxed if held two to five years, 40% taxed if held five to 10 years, and just 30% taxed if held more than 10 years.

This sliding scale lasted until 1938, when the system was slimmed to just three possibilities: short-term, long-term at 18 months, and super- long-term if held over two years. In 1942, the holding period to achieve long-term status went down to six months and stayed there until 1977.

In 1977, the minimum holding to get long-term treatment was changed to nine months. In 1978, it was changed to 12 months, where it sat until 1986, when long-term gains lost their preferential treatment.
In 1991, the clock was set back to pre-1986 status in which long-term gains got a tax break if the asset was held for more than 12 months; 1997 added a super long-term benefit at 18 months (this was yanked after a year), and that brings us to where we stand today.

Clearly, we can do all the tax planning we want, but we must not ignore the fact that the assumptions we make are just that: assumptions. What if one continually defers gains, only to find out that when sold there is no longer a capital gains break (as from 1986 through 1991)?

I am not predicting anything specific here, just observing that tax rates have been low for the past few decades and the pendulum usually swings both ways.

*Robert N. Gordon (bob@twenty-first.com) is chief executive of Twenty-First Securities Corp., and an adjunct professor at New York University's Leonard N. Stern School of Business.*