

Office of Government Ethics

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**Memorandum dated April 26, 1999,
from Stephen D. Potts, Director,
to Designated Agency Ethics Officials
Regarding Frequently-Asked
Questions about Certificates
of Divestiture**

Since the Certificate of Divestiture (CD) program was first authorized by statute in 1989, the Office of Government Ethics (OGE) has issued over 1,000 certificates. Our experience in administrating the program indicates that there are recurring issues that arise in CD cases. The attached document addresses those issues by providing a summary, in question and answer format, of the rules and policies that apply in most situations. We hope this document answers most of the questions you may have; but if you find you have additional questions, please do not hesitate to contact this Office for guidance.

Attachment

THE BASICS

1. What is a Certificate of Divestiture (CD)?

A Certificate of Divestiture is a document issued by the Director of the Office of Government Ethics that will allow, for those who are eligible, the sale of property without currently paying capital gains tax. The capital gains tax is deferred by a provision of the tax laws.

2. What is the objective of the CD program?

The purpose of the program is to minimize the burden that may result from incurring capital gains on the sale of assets because of the conflict of interest laws.

3. When may the Director issue a CD?

Section 1043 of the Internal Revenue Code permits the Director of OGE to issue a CD for specific property required to be divested. The procedures for obtaining a CD are described in regulations published by OGE at 5 C.F.R. part 2634, subpart J. To issue a certificate, the Director must determine that the person asking for a certificate is eligible under the regulations and that certification is reasonably necessary to comply with 18 U.S.C. § 208, or any other Federal conflict of interest statute, regulation, rule, or Executive order, or is pursuant to the request of a Congressional committee as a condition of confirmation.

ELIGIBILITY

1. Who is eligible to receive a CD?

The following persons are eligible to receive CDs:

- (a) Any officer or employee of the executive branch of the Federal Government, except a person who is a special Government employee (as defined in 18 U.S.C. § 202);
- (b) Any person who is married to, or the minor or dependent child of, an individual referred to in part (a) of this answer; and

- (c) Any trustee holding property in trust in which an individual referred to in part (a) or part (b) of this answer has an interest.

2. Should an individual count on getting a CD?

Not necessarily. Whether a CD will be available is a technical matter that requires the analysis of a number of issues. Therefore, we urge you not to assure employees that a CD will be issued in every case. Such a commitment may be made only by senior officials of OGE after review and analysis of all materials pertaining to the specific situation. We understand, of course, that the potential availability of a CD can be very important when employees are required to divest. Therefore, OGE will be happy to consult with you so that you may give employees a preliminary analysis of the likelihood of a certificate being issued in particular cases.

3. Can a CD be issued for property that already has been divested?

No, a CD cannot be issued for property that already has been sold. An employee must obtain the CD before selling the property required to be divested.

HOW TO REQUEST A CD

1. Who may request a CD?

Only the Designated Agency Ethics Official (DAEO) may request that OGE issue a CD. Other persons, including employees required to divest, may not make the request directly to OGE. Instead, eligible persons should submit their requests through the agency DAEO.

2. What information must be included in the DAEO's request?

The DAEO must submit a package of materials including the following:

- (a) A copy of a written request to the DAEO from the eligible person who is to divest the property. The eligible person's request must include:
 - (1) A commitment to complete the divestiture on or before a date specified in the request, in any event no later than the end of the three-month period from the earliest of -- (A) the date

that the property became a prohibited holding, (B) the date of an order to divest, or (C) the date of an ethics agreement to divest the property; however, OGE may agree in writing to extend the three-month period under special circumstances; and

- (2) Full and complete information concerning the facts and circumstances relating to the acquisition of such property and its contemplated divestiture;
- (b) A copy of the latest financial disclosure report filed by the employee; if the employee is not required to file a financial disclosure report, the request shall include a memorandum from the employee disclosing interests in property, income, liabilities, agreements and arrangements, and outside positions which are required to be disclosed on such a report;
 - (c) A detailed description of the specific property for which divestiture is contemplated;
 - (d) Complete statements of:
 - (1) The facts and circumstances relevant to whether there is a reasonable necessity for divestiture (including a description of the employee's position or applicable statutory citation setting forth the duties of the position); and
 - (2) Analysis and opinion from the DAEO applying the CD regulations to the case of the proposed certification. The DAEO's submission must indicate when the three-month period, within which divestiture must occur, will lapse.

3. What if the divestiture is being made at the request of a Congressional confirmation committee?

Instead of submitting the opinion of the DAEO that divestiture is reasonably necessary, the package submitted to OGE may instead include a written acknowledgment from the Chairman of the committee that the committee made such a request, a letter to the committee containing a promise by the individual to make

the divestiture of specified property in accordance with such request, or a transcript of Congressional testimony containing such a commitment by the individual in response to the request. However, all the other items required to be submitted and the other rules regarding CDs remain the same.

WHAT HAPPENS AFTER OGE ISSUES A CD

1. How will I know that a CD has been issued?

The DAEO will receive a transmittal letter and the Certificate of Divestiture signed by the Director of OGE. The certificate should be forwarded to the divesting individual as soon as possible. No property should be sold until the employee receives the certificate and confirms that the description in the certificate of the property to be divested exactly matches the property being sold.

2. What should an employee do after a CD is received and the property sold?

In order to complete the steps that will permit tax-deferral of capital gains from the sale, the divesting individual must make a reinvestment of the amount realized from the sale in "permitted property" during the 60-day period beginning on the date of sale.

3. What is the "permitted property" into which the reinvestment must be made?

"Permitted property" is limited to obligations of the United States and diversified investment funds as defined in the regulations at 5 C.F.R. § 2634.1003.

The regulations define a "diversified investment fund" as any open-end mutual fund, which by its prospectus, or any common trust fund maintained by a bank, which by the literature it distributes to prospective and current investors describing its objectives and practices, does not indicate the objective or practice of devoting its investments to particular or limited industrial, economic, or geographic sectors.

Under these rules, for example, the following types of funds offered generally by major fund families meet the

definition of permitted property: a Common Stock Fund, a Growth Stock Fund, an S&P Index Fund, a Global Fund (investing in common stocks worldwide), a Blue Chip Fund, a Corporate Bond Fund, a Municipal Bond Fund (which is not geographically limited), and a Government Bond Fund (which invests exclusively in obligations of the United States). On the other hand, the following types of funds offered generally by major fund families do not meet the definition of "permitted property": a Pacific Fund, a Mexico Fund, a New England Fund, a Gold Fund, a Commodity Futures Fund, a Venture Capital Fund, and a Drug Industry Sector Fund.

Note that a closed-end mutual fund, such as those listed on the New York Stock Exchange, could not be "permitted property." An additional rule is that not more than one percent of the market value of the fund can be attributable to the Government employee immediately after the reinvestment.

4. How does the divesting individual actually get the tax-deferral of capital gains?

An employee must file IRS Form 8824 with the income tax return for the year in which the property is sold. The IRS has jurisdiction over the rules relating to the tax aspects of a sale and reinvestment using a Certificate of Divestiture. Eligible persons should seek the advice of their personal tax advisors about the tax aspects of these transactions.

5. How will an individual know if the choice of "permitted property" for a reinvestment is going to be accepted by the Government?

The allowable types of "permitted property" into which reinvestments may be made have been chosen to ensure that most Federal employees will not have a further ethics problem. However, the ethics program rules for a particular agency or position may further limit the choices that are permitted. For example, there are restrictions on the purchase of obligations of the United States by some officials of the Department of the Treasury. The DAEO should give guidance in this regard. Ultimately, however, the IRS has jurisdiction with respect to whether reinvestments are within the definition of "permitted property" in specific cases.

SPECIAL MATTERS THAT AFFECT WHETHER A CD WILL BE ISSUED

1. Will a CD be issued if someone other than an eligible person holds an interest in a trust?

Possibly not. A CD may not be issued in such a case unless the parties take actions which, in the opinion of the Director of OGE, keep noneligible persons from receiving the benefit of the tax-deferral. The parties to the trust can take actions to exclude the other people, if permitted by State trust and estate law, such as dividing the trust into separate portfolios, making special distributions, paying out the property held by the trust, or anything else which in the Director's opinion is feasible. OGE has experience with these situations. We will try to work things out with the parties.

In such a case, along with the other material required to be submitted to OGE, the DAEO should submit:

- (a) A copy of the trust instrument, and
- (b) Full details about its current portfolio.

OGE must have adequate information to identify all persons who hold beneficial interests in the trust principal and income, and the relationships of those persons to the Government employee.

2. Will a CD be issued if the property to be divested was obtained through a former employer?

The tax law generally treats property received as compensation for services as ordinary income, and not as capital gains income for which a CD may be obtained. For example, where stock options are granted by an employer, a certificate may not be issued if the exercise of the option, or the sale of stock received upon exercise of the option, would result in compensation. Although the divesting individual may want to consult a personal tax advisor in these cases, the following types of transactions and occurrences commonly result in the realization of ordinary income by an employee:

- (a) **Shares of stock.** The receipt of shares of stock from an employer, or the sale of such shares that previously have not been taxed;

- (b) **Buy-out of an employment contract.** The sale or cancellation of an employment contract with a former employer;
- (c) **Nonstatutory stock options.** The grant of nonstatutory stock options that have a readily determinable fair market value, or the elimination from such options of a substantial risk of forfeiture. However, if the options did not have a readily determinable fair market value when granted, ordinary income is realized upon the receipt of the underlying stock when the option is exercised;
- (d) **Employee stock purchase plan options.** The sale of stock received through the exercise of an employee stock purchase plan option within two years after the option was granted or within one year after the stock is received;
- (e) **Incentive stock options.** The sale of stock received through the exercise of an incentive stock option within two years after the option was granted or within one year after the stock is received, or the sale of the stock at any time unless the individual worked for the employer for the entire period from the date that the option was granted until at least three months before it was exercised.

If, in spite of these general principles, the divesting individual still believes that there will be capital gains income from the sale of property received from an employer, the reasons should be explained in detail in the submissions through the agency to OGE. Often employers give their employees complete written explanations of how property given to them will be taxed. Copies of such material also should be submitted to OGE.

3. What other considerations go into issuing CDs?

In addition to the other rules, the Director of OGE will not issue a CD to an eligible person if, in his opinion, to do so would give an unfair or unintended benefit. Some common examples of these situations are described in the answers to the following four questions.

4. Will a CD be issued for interests in employee benefit plans?

Interests in pension, profit-sharing, stock bonus and other employee benefit plans do not qualify for CD treatment. Capital gains resulting from asset sales within such plans are not subject to current taxation.

5. What if the CD request is not made within the appropriate time period?

A CD will not be issued for any contemplated divestiture when the request is received by OGE more than three months after the earliest of -- (a) the date (with an additional ten-day grace period) that the property became a prohibited holding, (b) the date of an order to divest, or (c) the date of an ethics agreement to divest the property. For example, if the regulations of your agency prohibit employees from owning securities issued by companies operating in specific industries and a particular employee started employment with the agency on June 15, OGE would reject a request for a CD for that employee that was submitted to it after September 25. Extensions of time may be granted in accordance with 5 C.F.R. § 2634.1002(e)(4).

6. What if the employee owns similar or related property?

In many cases, an employee must sell all property similar or related to the property to be divested. Otherwise, OGE may not issue a CD because an unfair or unintended benefit would result. This issue may arise in many different ways. For example, a Government employee might have financial interests in a particular company both through direct ownership of shares and through the attribution of shares held in trust for a dependent child. The employee would not be issued a CD for the proposed sale of the directly held shares unless he also committed to sell the shares held in the trust.

Likewise, an employee might have financial interests in two companies that are both affected by the same particular Governmental matter (such as a regulation) which is to be the subject of the employee's next assignment. The employee would have to divest her interests in both companies in order to receive certificates in this situation. It should be noted that in some cases, similar or related property might be exempted under the *de minimis* rules of 5 C.F.R. § 2640.202 or be subject to separate treatment under other applicable rules. In such cases, there would not

be an unfair or unintended benefit if the exempt or separately treated property were not divested. Please consult with OGE as to whether a CD may be issued under the facts and circumstances of particular cases which raise these issues.

7. How will the timing or manner in which property was acquired affect whether a CD may be issued?

There would be an unfair or unintended benefit, and a CD will not be granted, if the property was acquired at a time when the holding of the property was prohibited by any law or regulation. For example, if the property was received as a gift from someone at a time when ownership of such property was prohibited by a regulation, a CD would not be granted. Similarly, a CD will not be granted under circumstances which otherwise would create the appearance of a conflict with the conscientious performance of Governmental responsibilities. Note that OGE has granted CDs for divestiture of prohibited property received through inheritance when all other requirements have been met.

COUNSELING EMPLOYEES WHO HAVE TO DIVEST

1. Do all eligible persons who must divest property ask for a CD?

In some divestiture cases, CDs simply are not sought. Our experience indicates that many of these situations involve small holdings, and the individuals conclude that they wish to avoid the burdens of participating in the process of requesting a CD and the additional personal tax filing that is required (IRS Form 8824), as well as to avoid the restrictions on reinvestments. In other cases, individuals do not seek a CD because they make frequent changes in their holdings and would not, therefore, benefit from a mechanism that will defer the capital gains tax only until they sell the property in which they have reinvested. Often, the issue is not faced because the property to be divested will be sold at a loss making the tax-deferral procedure inapplicable. Additionally, the capital gains issue is sometimes avoided through the gift of property to adult children or grandchildren, rather than a sale of the property.

2. How may employees react to being informed they may have to divest?

Very few of those employed in the executive branch are ever faced with the requirement of divestiture. However, for those who are required to divest property, it may be a stressful experience that can have a significant impact on personal finances and financial planning. Frequently, divestiture issues will also involve other family members whose interests are attributable to a present or prospective executive branch employee, and the issues may at times affect the estate plans implemented by additional family members such as parents and grandparents of the employee or his spouse. For many of those who must divest property for conflicts of interest reasons, the availability of a CD will mitigate the concerns they have about divestiture.

3. What should I always tell those who face a divestiture requirement?

The employees or prospective employees should always be told that -

- (a) A CD may be available;
- (b) CDs cannot be issued after the divestiture has already occurred; and
- (c) There is a distinction between the requirement to divest and the availability of a CD in a particular case.

MISCELLANEOUS

1. Where can an outside attorney, accountant, or other advisor look up the technical rules for the CD program?

The program is administered under section 1043 of the Internal Revenue Code of 1986, 26 U.S.C. § 1043, as implemented through regulations that start at section 2634.1001 of title 5 of the Code of Federal Regulations.

2. Will people outside of the Government be able to get copies of a CD?

Yes. The public can get copies of CDs under the same rules that permit access to public financial disclosure reports. See 5 C.F.R. §§ 2634.1004 and 2634.603.