

New capital gains rate: zero

You heard right. There's no -- nada, nothing, zilch, zero -- capital gains tax on the sale of assets held for more than a year.

But you might not have heard the full story.

Bob D. Scharin, senior tax analyst from the tax and accounting business of Thomson Reuters, calls the law that took effect Jan. 1, 2008, "the ultimate tax rate reduction." But as is often the case with tax provisions, this modification comes loaded with restrictions.

First, the elimination of capital gains tax applies only to assets owned for more than a year. Short-term sales remain taxed at your [ordinary tax rate](#).

Then there is a monetary cap, as well as a limited time frame to take advantage of the tax break.

And it's not for every investor. Some young investors have been expressly excluded from the zero-percent option. Others, such as Social Security recipients, could find that untaxed capital gains might mean new or additional taxes on their retirement benefits.

So before you rush to your broker to sell all your stocks and mutual funds, check out the new law's finer points and how it might or might not apply to you.

Cashing in on lower capital gains taxes			
For tax years 2008, 2009 and 2010, long-term capital gains taxes are eliminated for some low- and moderate-income individuals. This zero-tax break will end Jan. 1, 2011, when all capital gains rates revert to pre-2003 levels, unless Congress extends the current law.			
Ordinary income tax bracket	Long-term capital gains rate by tax year		
	2007	2008, 2009 and 2010	2011
10 percent	5 percent	0 percent	10 percent
15 percent	5 percent	0 percent	10 percent
25, 28 and 35 percent	15 percent	15 percent	20 percent

Limited to lower incomes

The first, and for most the biggest, hurdle to overcome is the earnings limit.

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Previously, taxpayers in the 10 percent and 15 percent tax brackets paid 5 percent on long-term capital gains. Now, individuals in the two lowest tax brackets can sell long-term assets and escape any capital gains taxes.

Beginning in 2008, those bracket limits and the potential tax savings by reducing the maximum capital gains rate from 5 percent to zero percent are as follows.

Income limit		
Filing status	Taxable income threshold	Maximum tax savings
Married, joint return	\$65,100	\$3,255
Head of household	\$43,650	\$2,182.50
Single and married, separate returns	\$32,550	\$1,627.50

While some taxpayers might look at the income limits and presume they can't take advantage of the zero-percent rate, that might not be the case. The reason: The cut-off amounts are taxable income, not the larger adjusted gross income amount.

"People are used to having deduction phaseouts tied to adjusted gross income," says Scharin. "This one is geared to taxable income."

Taxable, not gross, income

Taxable income, that amount on which you figure how much you owe Uncle Sam, is reached by starting with your gross, or total, income and subtracting any adjustments (also known as above-the-line deductions), your deductions (either standard or itemized) and your personal exemptions.

Depending upon your deductions, your gross income could be substantially more than the income threshold but you'd still be eligible for the zero-percent tax rate.

For instance, says Scharin, for the 2008 tax year, taxable income of \$65,100 for a married couple with two children and who use the standard deduction translates to an adjusted gross income of \$90,000.

Keeping some kids out

While retirees might benefit from the zero capital gains rate, another group that ordinarily would seem a good fit is locked out of the no-tax option.

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Young taxpayers usually are in the eligible 10 percent and 15 percent tax brackets. But a change in the kiddie tax, the law governing taxation of young investors' assets, prevents them from getting the zero percent rate.

Under the kiddie tax, if a child age 18 or younger (or up to age 23 if a full-time student) has investment income of more than \$1,800, those earnings are taxed not at the child's lower rate, but at the parents' top tax rate. So if mom and dad don't qualify for the zero capital gains rate, neither will their kids.

The age limit for the kiddie tax used to be lower, but Congress upped it in conjunction with the arrival of the zero percent capital gains rate. Lawmakers saw the ability of parents to shift income to their children who then could sell it and owe no tax as too big a loophole to leave in place.

Some young investors, however, still can get the tax break.

"I have a client whose daughter is just out of college, has her first job and is in the 15 percent tax bracket," says DeVine. "She has some funds that have had great appreciation and this is a great chance for her to grab some appreciation, diversify her portfolio and exchange to some funds that are performing better. This really benefits younger, pre-professional working adults."

Harrison-Suits agrees: "It works well for the lower income levels, which in many cases is younger people just getting started. If they have gifted or inherited stock, this is a good time to look at selling."

Figuring adjusted gross income	
Zero percent taxable income threshold	\$65,100
Standard married filing jointly deduction and	\$10,900
Personal exemptions (4 x \$3,500)	+ \$14,000
Adjusted gross income	\$90,000

And even if your total taxable income is more than the threshold amounts, you might qualify for some tax-free capital gains. "The zero percent rate does not phase out in the same way deduction phaseouts work," says Scharin. "You're looking at other income as

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well, and you get the zero percent capital gains rate to the extent that your other taxable income is below that threshold."

For example, consider a married couple with \$70,000 taxable income, with \$60,000 of that from wages and \$10,000 from capital gains. Although their taxable income exceeds their \$65,100 limit, says Scharin, they pay no tax on \$5,100 of the capital gains. That's the amount by which the taxable threshold exceeds their income that's subject to ordinary tax rates. And the excess \$4,900 in capital gains would be taxed at 15 percent, the regular capital gains rate for taxpayers in the 25-percent-and-above brackets.

While the use of taxable instead of adjusted gross income cutoff means more investors should be able to take advantage of the no-tax law, practically speaking, the change might not have that much of an effect.

"People at more moderate income brackets tend not to have a lot of capital gains," Scharin says. "They may have a mutual fund that paid out a little during the year."

Or, as Michael DeVine, a financial adviser and vice president with WealthTrust Arizona in Chandler, Ariz., points out, many zero-rate eligible individuals tend to invest primarily in tax-deferred retirement accounts, such as traditional IRAs or 401(k)s. In these cases, the elimination of the capital gains tax is of no use, as these holdings are taxed at ordinary income rates.

Kathy Harrison-Suits, an enrolled agent and vice president at Tacoma, Wash.-based Summit Capital Advisors, sees a similar pattern. "Typically what we find is people in those tax brackets are in two batches," she says. "They either have no savings and are not buying mutual funds and stocks so it has no effect on them, or they are retirees and pre-retirees whose incomes have dropped, and they have made investments and do have capital gains within their portfolios."

Planning possibilities and problems

The zero-percent tax rate has struck a chord with retirees, a large segment of the population in DeVine's state. But it also has presented some problems. "What I don't like about this is how (some advisers) are up-selling this to retirees," DeVine says. "It helps a few people, but even then it's not that easy to digest. And as adjusted net capital goes up, it could have some consequences."

For retirees, a major potential problem is that asset sales to take advantage of no capital gains taxes could actually increase their tax liability.

"There are some pitfalls," agrees Harrison-Suits. "Retirees drawing Social Security, when they initially figure their taxable income, may well be below the limits. But as their capital gains go up, so does the amount of Social Security that might be taxable. So we have a real tax planning issue that has to be looked at in a lot of different ways."

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"You do need to look at what it might do to the rest of your income," says Scharin. "While you might avoid the capital gains tax, it could raise your adjusted gross income, and that may cause more of your Social Security benefits to be taxed or it could potentially affect other deduction phaseouts."

However, because the no-tax rate is in effect through 2010, it gives qualifying taxpayers some maneuverability.

One option, says Harrison-Suits, is rather than selling all your holdings at once, consider incremental sales over the three years the tax break is in effect.

"Look at your income and determine how much capital gains you can take while still getting the zero capital gains rate," says Scharin. "You might want to sell some this year, another group of shares next year and the rest in 2010."

Rebalancing opportunity

The zero rate also might enable you to take some tax-free gains and readjust your portfolio's basis.

"In some cases, you may have had some shares of stock you've held for 10 or 15 years and had quite a bit of appreciation in it," says Scharin. "That would make 2008 a good year to sell and then reinvest the gains in whatever else fits your plans."

That's the case for one of DeVine's clients, who has some inherited stocks that have had huge appreciation. "They are early retirees, so they have no Social Security taxes to worry about," he says. "They are in that sweet spot where they can take advantage of basis step-up."

In fact, DeVine's clients and others in the same situation could sell such long-held, greatly appreciated stock and then immediately buy it back if it still fits into their overall investment plans. By doing this, they get a step up in basis, i.e., a greater value of the asset used to calculate gain. When the asset is eventually sold for the final time, the gain and therefore the ultimate tax bill will be less.

And there's no need in this case to worry about the [wash sale rule](#), which prohibits the repurchase of the same or substantially similar stocks that have been sold within 30 days. It applies only to capital losses, not gains.

Lost capital losses

But in some cases, capital losses could be problematic when capital gains are not taxed.

Capital losses must first offset any capital gains. But, when the gain is zero, there is nothing to offset. You could use up to \$3,000 of the losses to reduce ordinary taxable

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income, but essentially in this case, you are wasting the loss' full tax-saving potential since there is no corresponding capital gains.

"People who are eligible for the zero percent rate on capital gain derive no tax benefit from offsetting those gains with capital losses," says Scharin. "If possible, they should defer the losses into a future year when they either have no capital gains or the gains are subject to tax."

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