Capital Gains Planning: 2010 Sunset Date Begins to Matter

This coming January officially marks the three-year countdown before the axe falls on the lower individual capital gains rates now in place.

Since May 6, 2003, thanks to the Jobs and Growth Tax Relief Reconciliation Act of 2003, gain from the sale of most long-term capital assets is subject to a maximum tax rate of 15 percent (5 percent for individuals in the 10 percent or 15 percent tax bracket). Starting in 2011, however, these rates are scheduled to revert to their former pre-May 6, 2003, levels of 20 percent and 10 percent, respectively. Nevertheless, before the party ends, a 0 percent rate will replace the 5 percent rate for tax years beginning after December 31, 2007.

Unfortunately, not all capital gain shares in this dramatic tax reduction: gain on collectibles remains subject to a maximum rate of 28 percent, and unrecaptured Section 1250 gain continues to be subject to a maximum rate of 25 percent, both now and after 2010. The majority of capital gains subject to tax, however, are included in the favorable, but still officially temporary, rate reduction.

Several GOP lawmakers recently emphasized how lower tax rates on capital gains and dividends have generated an increase in tax receipts, as well as sustained economic growth. While precise measurement of the impact of lower capital gains may be difficult, so is an accurate prediction of the future impact of allowing the maximum capital gain rate to revert to a 20 percent rate after 2010.

What is certain, however, is that taxpayers with long-term capital gains clearly won't benefit, at least in the short run. With this realty in mind, it may not be too early to start lining up some tax strategies to help soften the blow.

Prior to the 2003, general reduction of the maximum capital gains rates to current levels, one tax benefit that had been gaining momentum was the reduced rates for "five-year property."

Under that scheme, which had been effective since 2001, any gain from the sale or exchange of property held for more than five years that would otherwise be taxed at the then-10 percent rate was taxed at an 8 percent rate. Any gain from the sale or exchange of property held more than five years and after December 31, 2000, and otherwise taxed at the then-20 percent rate, would be taxed at an 18 percent rate.

This favorable treatment for five-year property was first sidelined by the 2003 act, when the general capital gain rate was lowered to the maximum 15 percent rate subject to sunset after 2008. The Tax Increase Prevention and Reconciliation Act of 2005 then extended the sunset for two more years, to 2010.

This sunset, rather than repeal, of the five-year property rate, however, means that five-year property suddenly is again relevant. Any capital asset purchases on December 31, 2005, for example, will be entitled to an 18 percent rate if sold after December 31, 2010, and if Congress makes no further changes. While the two-percentages-point rate differential between a maximum 18 and 20 percent rate may not control a sell-or-hols decision now, the closer one gets to 2011 and a five-year holding period, the more relevant the five-year property "discount" on the capital gain rate will become.

As the sunset provisions are currently written, installment sales agreements that defer the recognition of capital gain proportionately to the year that each payment based on the usual rule: that is, the rate in effect for the year that each payment is made. Those who enter deferred payment sales that extend beyond 2010, therefore, should keep in mind the higher rate of tax for that portion of capital gain postponed until after 2010.

Deferring tax using the Code Section 1031 like-kind provisions is usually preferable to immediately recognizing the gain, since more asset value may then be rolled over into a new investment. With the possibility of capital gains rates going up in 2011, however, taxpayers should start to determine when they might want to liquidate their investment and, if relatively soon, further determine whether accelerating recognition under the now guaranteed low tax rates produces the more favorable result.

With many homeowners already bumping against the maximum $250,000 for single individuals or $500,000 for married couples capital gain exclusion on the sale of their principal residence, those making plans to maximize their savings have the added incentive of definitely coming under the lower capital gain rates if they sell (and close) before 2011.

Alternatively, they can roll the dice and hope that Congress raises the home-sale exclusion amount, set back in 1998, before then, or that Congress extends the lower capital gains rates.

Several modifications to the S corporation rules in the Small Businesses Tax Act of 2007 will help small businesses keep the tax benefits of being an S corporation. One is the defusing of part of the passive investment income test that had been a time bomb for many S corporations. The Small Business Tax Act eliminates some of the worry by no longer characterizing capital gain from the sale of stock or securities as passive investment income.

Dealing with pending re-instatement of higher capital gains rates in 2011, unfortunately, is not the only current planning consideration in play when crafting capital gain tax reduction strategies. Planning around the "Kiddie Tax" is a reality that must be faced immediately for many families but with 2011 in mind.

Just when the parents of thousands of college-bound students were looking forward to having their children's appreciated college nest egg liquidated in 2008 and 2009 at a 0 percent capital gain rate, Congress "moved the cheese" - twice! Last year, the age limit was increased retroactively from under 14 to under 18 (after being under 14 for several years). The Small

Business Tax Act of 2007 has now switched the rules again, moving the reach of the Kiddie Tax starting in 2008 to under 19 generally and to under 24 for full-time students.

In reaction, those not subject to the Kiddie Tax in 2007 but subject to it again starting 2008 should consider liquidating the child's portfolio immediately. However, planners should keep in mind that once a "kiddie" has too much other income (more than $31,850 in taxable income based on 2007 rate schedules, for example), they will be in the same 15 percent capital gain rate as their parents, foreclosing any additional tax savings through planning.

Starting in 2008, those families who do not need to dip into a "kiddie-owned" nest egg for college should consider postponing the liquidation of their child's appreciated securities until age 23, possibly to fund post-graduate education. However, such anticipated liquidation after 2010 runs the risk of being subject to the re-instated pre-2003 10 percent and 20 percent maximum rates. If liquidated now and subject to the Kiddie Tax, a maximum 15 percent rate of the parent would apply. Thus, paying the Kiddie Tax now, at least on a portion of the appreciation on the child's nest egg, might in fact be the more conservative approach at this juncture.

One "stealth tax" resulting from the recognition of capital gains will not go away, whether or not the capital gains rated after 2010 return to their higher levels. This stealth tax is the result of the full amount of capital gain increasing adjusted gross income just as much as ordinary income. As a consequence, all deductions and contribution limits based on adjusted gross income may be impacted by the amount of capital gain recognized, irrespective of the rate at which such capital gain is taxed.

AGI-sensitive (and, therefore, capital gain-sensitive) tax benefits include the floors for miscellaneous itemized deductions, medical expenses, casualty losses, charitable contributions, and a variety of phase-out levels, including those for personal exemptions, the child tax credit, the dependent care credit, the Hope and Lifetime Learning Credits, and the rental real estate passive-loss exception.

If several of those adjusted gross income caps, apply, someone in the 35 percent income tax bracket can find that an amount realized as capital gain is not only taxed at 35 percent, because of its indirect impact of exposing an equal amount of ordinary income to the taxpayer's marginal tax rate!

The Kiddie Tax and the AGI limits aside, the wild card in capital gain planning right now is what Congress will do before 2011. Will it extend the lower capital gains rated permanently, lower them only a bit, or perhaps even raise them to beyond pre-May 6, 2003 levels? Cautious planning requires attentiveness to all three possibilities, as will as to the possibility that Congress will do nothing.

A legislative solution this year, or even in 2008 before the presidential election, appears unlikely. While we must live with this uncertainty, covering our bets in the meantime by starting to allocate some gain recognition to pre-2011 years is starting to make more sense, if not now, the soon.