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Zero Percent Capital Gain Rate – Does It Apply to Me?

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Overview

Under present law, 2010 is the final year in which capital gains and qualified dividends will not be subject to tax in the hands of certain individual taxpayers – those in the two lowest tax brackets. This zero percent rate became available beginning in 2008 and raises significant planning questions and opportunities for lower-income taxpayers, and other taxpayers that can utilize tax management strategies to minimize income to take advantage of the zero percent rate.

Status of Current Law

Individual income tax rates. Presently, the ordinary income marginal tax brackets for individuals are 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent.[1] For 2010, the individual income tax brackets (for both mfj and single status) are as follows:

2010 - Married Filing Jointly/ Qualifying Widower			
Taxable Income			Tax Rate
Over		But Not Over	
$ 0	to	$16,750	10.0%
$16,750	to	$68,000	15.0%
$68,000	to	$137,300	25.0%
$137,300	to	$209,250	28.0%
$209,250	to	$373,650	33.0%
$373,650	&	over	35.0%

2010 - Single			
Taxable Income			Tax Rate
Over		But Not Over	
$ 0	to	$8,375	10.0%
$8,375	to	$34,000	15.0%
$34,000	to	$82,400	25.0%
$82,400	to	$171,850	28.0%
$171,850	to	$373,650	33.0%
$373,650	&	over	35.0%

Note: The standard deduction for 2010 is $11,400 (mfj) and $5,700 (single). The personal exemption for 2010 is $3,650.

Capital gains and qualified dividends. According to the table on page 2, capital gains are presently taxed at either a 15 percent or zero percent rate. But, the table also shows that, beginning in 2011, these rates will sunset and will be replaced with higher rates. That means that, beginning in 2011, capital gains (and qualified dividend income) will lose their favorable status, and will be taxed at the rates that existed through May 5, 2003 - either 20 percent or 10 percent for capital assets held more than 12 months.

Capital Gaines Rates/Holding Periods			
Transaction Date of Sale	**Holding Period**	**Tax Rate 10% - 15%**	**Tax Rate 25% - above**
Prior to 5-7-97	More than 12 months	15%	28%
5-7-97 thru 7-28-97 (Mid-term)	More than 12 months	10%	20%
7-27-97 thru 12-31-97	12 months to 18 months	15%	28%
7-29-97 thru 12-31-97	More than 18 months	10%	20%
1-1-98 thru 5-5-03 1-1-11 and after	More than 12 months	10%	20%
1-1-01 thru 5-5-03 1-1-11 and after	More than 5 years	8%	18%** N/A
5-6-03 thru 12-31-07	More than 12 months	5%	15%
1-1-08 thru 12-31-10	More than 12 months	0%	15%

**Note: The 18 percent rate only applies to assets whose holding period began after 2000. Thus, sales eligible for the 18 percent rate would not occur before 2006. With a change in the law in 2003, this provision will not apply until 2011.

The Zero Rate for 2010

At least for now, 2010 remains a tax-advantaged year for taxpayers with capital gains (technically, adjusted net capital gains (ANCGs)) in the 10 percent or 15 percent tax brackets. In other words, the zero rate applies to the slice of capital gains that falls between the taxpayer's ordinary income and the top of the 15 percent bracket, as illustrated by the following example:

> **Example 1:** John and Marcia, a married couple, have $50,000 in ordinary income from wages and interest. In 2010, they sell farmland that they have owned for many years for $600,000. They don't have any on-farm heirs, and decided to sell their farmland and use the sale proceeds as retirement income. Their adjusted income tax basis in the land is $225,000, so their profit which is subject to long-term capital gains tax is $375,000. On their tax return for 2010, their adjusted gross income (assuming no income from other sources) is $425,000. After deducting the standard deduction with two personal exemptions, they have taxable income of $406,300. Of this amount, $31,300 is taxed as ordinary income. The resulting tax is $3,857.500. Of the remaining $375,000, they will pay zero tax on $36,700 (that's the top end of the 15 percent bracket ($68,000) less the amount taxed as ordinary income). The remaining $338,300 is taxed at 15 percent, which is the long-term capital gains rate paid by people in the 25 percent bracket and above. The tax on this amount is $50,745. So, the savings from the zero percent rate is $5,500 (assuming the $36,700 would have been taxed at 15 percent).[2]

How is ANCG Calculated?

The favorable capital gains and qualified dividend tax rates apply to ANCG - that's net capital gain (NCG), defined as net long-term capital gains minus net short-term capital losses[3] ANCG also includes qualified dividend income (QDI), as long as the dividends are not treated as investment income when determining the amount of deductible investment interest expense. The bottom line, however, is that for most taxpayers, ANCG is simply the sum of net capital gains from the sale of real estate, stock, bonds, or mutual funds, plus QDI.

Computation of the Tax

As indicated above, the 5 percent or zero percent rates apply only to the extent that ANCG would be taxed at 10 percent or 15 percent if it was ordinary income. Otherwise, it's taxed at 15 percent. So, the favorable tax treatment afforded ANCG depends on the amount of the taxpayer's taxable income minus ANCG (i.e., non-ANCG, such as interest income, retirement plan

distributions, and taxable Social Security benefits).

Here are some further examples to help explain the calculation:[4]

> **Example 2:** In 2010, Bob's total income is $34,000 which includes $20,000 of ANCG. Bob's filing status is single. Because his total income (without even factoring in the standard deduction and personal exemption) is within the taxable income amount at the top of the 15 percent bracket ($34,000 for a single taxpayer), the entire $20,000 of Bob's ANCG is tax-free.
>
> **Example 3:** In 2010, Larry and Matilda (a married couple) have (non-ANCG) ordinary income of $30,000. They also have $24,000 of ANCG. Thus, their adjusted gross income is $54,000. After deducting the standard deduction ($11,400) and two personal exemptions ($7,300), their taxable income is $35,300. Of this amount, $19,611.11 is taxed as ordinary income. The tax on that amount is $2,344.17. Of the remaining, $15,688.89, Larry and Matilda will pay zero tax because it is within the top end of the 15 percent bracket.

Who Is Likely to Benefit From the Zero Percent Tax?

As pointed out by Sumutka, Sumutka and Margarido, the primary potential beneficiaries of the zero percent rate include retirees, prospective retirees, some semi-retirees, and some other taxpayers, including children.[5] With proper planning these taxpayers could generate income, implement various asset management strategies, or satisfy gift and income shifting objectives at no tax cost. Sumutka, Sumutka and Margarido make the following observations concerning the potential impact of the zero percent rate on various types of taxpayers:

- **Current workers.** The authors believe that working persons are unlikely to be able to utilize the zero percent rate due to a lack of ANCG or QDI. The authors point out that lower-income workers may typically be in the low income tax brackets, but may lack the means (or discipline) to save or generate ANCG. Middle-income workers, they point out, usually straddle the 15% and 25% brackets, but tend to initially save in tax-sheltered retirement accounts and only later in taxable accounts. High-income earners exceed the tax bracket threshold.

  > **Note:** Some working married couples in the $80,000-$100,000 combined income range might qualify if they have enough deductions on Schedule A (itemized deductions) to get them under the joint $68,000 threshold.[6]

- **Prospective retirees.** The authors point out that persons that are contemplating early retirement may be in the best position to exploit the zero percent tax rate – especially if they have options as to how they can take their retirement income.

- **Retirees.** The authors also state that older retirees (those aged 85 and above who experienced the Great Depression) often saved regularly in taxable accounts, which now represent appreciated assets.[7] These persons typically live on modest incomes derived from Social Security benefits, pensions, traditional IRAs, and QDI. But, many of these persons may be in a marginal tax bracket, which may limit their ability to utilize the zero percent rate on ANCG or QDI.[8]

- **Semi-retirees.** The authors suggest that semi-retirees, particularly those who have delayed Social Security and retirement plan benefits, may have tax planning opportunities.

- **Taxpayers with children.** The authors state that because many children are in the low income tax brackets, parents may be able to

utilize gifts and other income-shifting strategies to help the parents utilize the zero percent rate. For example, the parents could make present interest annual exclusion gifts (currently $13,000 per year, per donee), preferably in appreciated assets, to each child.

> **Note:** The "Kiddie Tax" rules have to be carefully watched in this situation.[9] But, if the "Kiddie Tax" can be avoided, the child can sell the asset for fair-market value (which would be at a gain due to the low carryover basis in the child's hands that applies to gifted property), but with no tax.[10]

- **Non–Social Security recipients**. The authors point out that this category generally includes most prospective retirees, early retirees who are not yet eligible for or have elected to delay Social Security benefits, and those retirees age 65 or older who do not collect Social Security. It is the authors' belief that these individuals may be most likely to fall within the 15 percent tax bracket.

- **Social Security recipients.** In the authors' view, the tax bracket of these persons at the median income level for the group is likely no higher than 15 percent. Thus, they conclude that these persons can shelter non-ANCG up to at least the sum of the standard deduction plus personal exemptions (in 2010, that is $9,350 for single filers and $15,050 for joint filers age 65 or older).

> **Note:** Caution should be taken when trying to use strategies to realize zero percent capital gain recognition for retirees. The added AGI from the sale of a long-term capital gain may trigger a taxable phase-in of Social Security benefits at either a 50 percent or 85 percent rate.

What About Farmers? Shifting and "Massaging" Farm Income to Utilize the Zero Rate

Ideally, for active farmers that are planning on triggering capital gain income in 2010, the best tax strategy is to minimize taxable income in 2010. The goal is to try to keep the income within the top end of the 15 percent bracket. Considerations for farm clients on this point include the following:

- Use expense method depreciation for purchases of farm machinery and equipment. In 2010, the maximum expense method depreciation amount drops to $134,000 (down from $250,000 in 2009). But, that is still a significant amount of depreciation that can be claimed on qualified assets.

- Accelerate income into 2009 and/or defer expenses until 2010. For example, income that would normally be deferred to 2010 could be received in 2009, and expenses that would normally be incurred and deductible in 2009 (such as by pre-paying) could be put-off until 2010.

- Elect farm income averaging.[11] This is a particular useful strategy that is available to farmers if 2010 income will be higher than the three prior years. By making an income averaging election, a farmer can remove some of the income from 2010 and spread it over the three prior tax years. Such a move may push 2010 income down far enough to allow at least partial utilization of the zero percent rate on capital gains in 2010.

  Notes on farm income averaging:

  - The provision is available for taxpayers engaged in the business of farming or fishing – included in the definition (under I.R.C. §267(c)) are the cultivation of land or the raising or harvesting or any agricultural commodity (including the operation of a sod farm or nursery); raising or

harvesting of trees bearing fruit, nuts or other crops; and the raising of ornamental trees. However, a "farm business" does not include contract harvesting of commodities.

- A taxpayer with farm income during the year as a sole proprietor, partner in a partnership or shareholder in an S corporation can use the provision regardless of whether the taxpayer was engaged in a farming business in any prior year.

- Income that is eligible to be averaged is called "elected farm income" (EFI) and is the amount of taxable income attributable to a farming business that the taxpayer specifically elects to be averaged. EFI includes net Schedule F income, gain from the sale or disposition of property (other than land or timber) regularly used by a farmer for a substantial period in the farming business, and the taxpayer's share of net farm income from a partnership, S corporation or LLC. A landlord's share of crop-share lease income may be included in EFI – material participation is irrelevant.

- Any combination of capital gain and ordinary income can be averaged – put the portions of income attributable to each must be allocated in equal portions among the tax brackets of the three prior years.

- In computing alternative minimum tax, regular tax liability is determined without regard to farm income averaging.

Don't Forget About Basis

Before a capital asset is sold in 2010 in an attempt to take advantage of the zero percent rate on capital gains, income tax basis in the asset to be sold will need to be determined.

Here are some quick pointers on determining basis based on the type of asset sold:

- Stocks – generally basis is the purchase price of the stock. But, that can be altered by any brokerage commissions and fees that have been paid. Nontaxable distributions (shown on Form 1099-Div) reduce basis (it's a return of capital). Also, there are various types of stock that could be involved – employment-related stock (that is held, for example, by a farmer's spouse), non-qualified stock options, restricted stock options and incentive stock options. Each one of these categories of stock is subject to specific rules that require tax advice with respect to basis determinations before such stock is liquidated.

  Note: The "wash sale" rule,[12] if triggered, can also impact basis. A "wash sale" involves a sale of stock and/or securities resulting in a loss combined with a (substantially) identical stock (or security) purchased within 30 days before or after the sale. The rule denies the recognition of a loss on the sale. The rule does not apply to gains and repurchases.

- Mutual funds – the IRS has specific basis tracking rules that are to be followed to determine income tax basis in a mutual fund.

- Real estate – generally a taxpayer's basis in real estate is its purchase price. However, basis is adjusted upwards for improvements to the property and by any depreciation allowable on depreciable improvements.

- Timber – for trees the taxpayer planted, basis is the cost of the original trees. For land that had trees on it when purchased, an allocation of the purchase price must be made between the land and the trees. If the land was received by gift or inheritance, an allocation must still be done.

- Vacation property – generally basis is the purchase price increased by improvement

and decreased by losses that are recognized and any insurance proceeds that are collected.

Not all property is purchased. Property received by inheritance receives (under current law) a new basis at death in the hands of the heir that is equal to the fair market value of the property as of the decedent's date of death. That means that when inherited property is later sold, the date of death basis is subtracted from the sale proceeds with the heir (as seller) owing capital gain tax only on the difference.

> **Note:** Under current law, however, in 2010 the fair market value at date of death basis rule is replaced with a modified carry-over basis rule. Under that rule, carry over basis (the decedent's basis) applies to assets above $3 million that are inherited by the decedent's spouse, and assets of more than $1.3 million that are inherited by anyone else. In 2011, the fair market value basis rule is set to return – but federal estate tax will apply on taxable estates exceeding $1 million (with a maximum tax rate of 55 percent).

Property may also be received by gift. For gifted property, the donor's basis carries over to the donee. But, the donee's basis can be increased in situations where the donor pays federal gift tax on the transfer. The donee can add the amount of the gift tax that is attributable to the appreciation in value of the asset as of the date of the gift to the amount of basis that carries over from the donor.

Summary

Clearly, planning possibilities abound surrounding the zero percent rate for capital gains and qualified dividend income for years 2008-2010. But, the provision is clearly limited to those with relatively low incomes. In addition, sound overall tax planning still requires that a broad perspective be taken with respect to current and future income projections, potential changes in the law, and a taxpayer's overall tax, estate planning and financial planning goals.

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[1] I.R.C. §1.

[2] The example is simplified. The real tax savings could be complicated by many factors. For example, if John and Marcia were collecting Social Security the possible taxation of Social Security benefits could offset some of the benefit of the zero percent tax rate. The taxable phase-in of social security benefits could be at a 50 percent or 85 percent inclusion ratio. Also ignored is the impact of the alternative minimum tax, which could, in this example, increase tax by approximately $9,000.

[3] Excluded from the computation are income from the sale of collectibles, IRC §1202 qualified small business stock (both of which are taxed at no more than 28%), and sales of depreciable real property (i.e., unrecaptured section 1250 gain, which is taxed at no more than 25%).

[4] For additional examples and more detailed discussion of the issue see, Alan R. Sumutka, Andrew M. Sumutka and Gina S Margarido, "Planning for the 2008-2010 Zero-Percent Adjusted Net Capital Gain Rate," The CPA Journal, December 2006.

[5] Alan R. Sumutka, Andrew M Sumutka and Gina S. Margarido, "Planning for the 2008-2010 Zero-Percent Adjusted Net Capital Gain Rate," The CPA Journal, December 2006.

[6] With enough mortgage interest and charitable deductions (and even the standard deduction and personal exemptions totaling), the $68,000 threshold (i.e., the top of the 15 percent bracket in 2010 for married persons filing jointly) may not be that difficult to make for many couples.

[7] The authors cite the *2006 Investment Company Fact Book* for the proposition that, in 2005, 37 percent of households aged 65 or older owned mutual funds, mostly outside of a defined-contribution plan, and another 37 percent of equity investors owned only individual stocks.

[8] These persons may be interested in building cash reserves for medical expenses or nursing home care.

[9] But, for tax years beginning after May 25, 2007, the "Kiddie Tax" applies to individuals age 18-23 who: (1) attained age 18 before the close of the tax year (whether a student or not); or were age 19-23 during the year and a full-time student (at least 12 semester hours) during at least 5 months of the year; (2) did not have earned income exceeding one-half of the

amount of their support for the year; (3) has unearned income for the year exceeding the annual threshold ($1,800 for 2008); (4) has one or both of their parents alive at the end of the year and are in a higher marginal bracket than the child; and (5) does not file a joint return.

[10] The authors correctly point out, however, that the receipt or sale of assets by a child at that time, typically the first year of college, may adversely impact a student's financial aid. Therefore, the authors observe that such gifting (by parents or grandparents) and selling is best deferred until after the child's first semester of their junior year, when a student's financial status is no longer evaluated.

[11] I.R.C. §1301.

[12] I.R.C. §1091.