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The Alliant Team

Year-end tax-saving strategies for those with appreciated capital assets

Two important tax changes going into effect next year raise capital gains tax planning opportunities for many taxpayers. The first is the zero percent tax rate on capital gains that will apply to taxpayers in the two lowest tax brackets. The second is a broadened kiddie tax that will reach more children than ever before. This issue takes a look at the year-end planning implications of these two changes.

Zero capital gains rate coming for some. A non-corporate taxpayer's net capital gain (but not collectibles gain, section 1202 gain or un-recaptured section 1250 gain) is taxed at a maximum rate of 15%. However, if the adjusted net capital gain would otherwise be taxed at a rate below 25% if it were ordinary income, it is taxed at a 5% rate this year, but will be subject to a zero percent rate for 2008 through 2010 (Note that qualified dividend income also is taxed at the 15%/5% rate this year and 15%/0% rate next year.)

Kiddie tax changes. A child subject to the kiddie tax pays tax at his or her parents' highest marginal rate on the child's unearned income over $1,700 (for 2007) if that tax is higher than the tax the child would otherwise pay on it. For 2007, a child is subject to the kiddie tax if, he or she has not attained age 18 before the close of the tax year; either parent of the child is alive at the end of the tax year; and the child does not file a joint return for the tax year.

Effectively beginning in 2008, under the Small Business and Work Opportunity Tax Act signed into law on May 25, 2007, the kiddie tax rules also apply where:

> … the child turns age 18, or turns age 19-23 if a full-time student, before the close of the tax year;
>
> … the child's earned income for the tax year doesn't exceed one-half of his or her support;

... the child has more than the inflation-adjusted prescribed amount of unearned income (projected to be $1,800 after an inflation adjustment);

... the child has at least one living parent at the close of the tax year; and

... the child doesn't file a joint return for the tax year. (Code Sec. 1 (g)(2)(A))

Year-end tax saving strategy #1. A taxpayer whose top dollars won't be taxed at more than 15% this year or next, and who is considering the sale of appreciated capital assets before year end, should instead defer the sale until next year. By doing this, the taxpayer could end up paying zero tax on his gain instead of paying 5% if he sold this year. This should be done only if (1) deferring the sale is not likely to result in a reduced sales price, and (2) the taxpayer is not likely to be subject to the kiddie tax next year.

Year-end tax-saving strategy #2. Higher-bracket taxpayers should consider making year-end gifts of appreciated capital assets to low-bracket family members, who can then sell the assets next year and achieve an overall 15% tax savings for the family.

E-Tips Illustration : The Smiths will be in the 28% bracket this year and next year. Jack, their 22-year-old son, has finished college and needs cash to start a business. The Smiths' assets include stock they bought for $5,000 and which is now worth $20,000. If the Smiths sell the stock this year to give Jack the cash he needs, they'd pay a tax of $2,250. If they give him the stock, and he sells it next year for $20,000, the entire $15,000 of built-in gain will be tax-free (assuming Jack's top dollars won't be taxed at more than 15%). If they haven't made other gifts to Jack during 2007, their gift of stock also will be gift-tax-free. That's because the first $12,000 of gifts ($24,000 for married couples who split gifts) made by a donor to each done in 2007 is excluded from the amount of the donor's taxable gifts.

Year-end tax-saving strategy #3. Before the Small Business and Work Opportunity Tax Act was passed by Congress, some wealthy (and some moderate-income) parents gifted appreciated stock, mutual-fund shares, and other securities to their low-income, young-adult children. They assumed these children could (if no longer subject to the kiddie tax rules and if in one of the two lowest tax brackets) then sell the securities tax-free in 2008 through 2010. The new law change eliminates the opportunity to achieve this goal in many cases. In this situation, a child who has already received a gift of, say, stock and was planning to sell it next year to take advantage of the 0% capital gains rate, but who would be snared by the expanded kiddie tax, should sell it this year to take advantage of the 5% rate. If he waits till next year, he'll pay a 15% tax on the gain. Note that this won't work if the child also is subject to the kiddie tax this year.

Year-end tax saving strategy #4. Higher-bracket parents who haven't done so yet should consider gifting appreciated capital assets to a low-bracket child who isn't in kiddie tax territory this year but will be next year. The child can sell the assets before the end of 2007 and achieve a 10% tax savings for the family (he'll pay a 5% tax instead of the 15% tax his parents would pay).