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Planning for the 2008–2010 Zero-Percent Adjusted Net Capital Gain Rate

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DECEMBER 2006 - The current ordinary income tax rates for individuals are 10%, 15%, 25%, 28%, 33%, and 35%. Certain capital gains and qualified dividends (i.e., adjusted net capital gains) are taxed at 15%, or 5% for taxpayers in the 15% or 10% tax brackets. Pursuant to the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) and extended by the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), the 5% rate drops to 0% from 2008 to 2010. In 2011, these rates will sunset and revert to the pre-2001 rates of 15%, 28%, 31%, 36%, and 39.6%. Qualified dividend income (i.e., dividends from most domestic corporations and certain qualified foreign corporations) will lose its favorable status, and capital gains rates will revert to pre-2003 rates, generally 20% (10% for gains in the 15% bracket) and the special five-year holding period rules. Some commentators speculate that, under certain circumstances, the favorable rates may be rescinded after 2008, which is a presidential election year.

At least for now, 2008–2010 are tax-advantaged years for taxpayers with adjusted net capital gains (ANCG) in the 10% or 15% tax brackets. Potential beneficiaries include retirees, prospective retirees, some semiretirees, and parents and children. With proper planning these taxpayers could generate income, implement various asset management strategies, or satisfy gift and income shifting objectives at no tax cost.

Calculation/Taxation of ANCG

The favorable capital gains and qualified dividend tax rates apply to ANCG. Technically, ANCG includes net capital gain (NCG), defined as net long-term capital gains minus net short-term capital losses, but excludes sales from collectibles, IRC section 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%). 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. For most taxpayers, ANCG is simply the sum of net capital gains from the sale of stock, bonds, or mutual funds, plus QDI.

The 5% or 0% rate applies only to the extent that ANCG would be taxed at 10% or 15% if it was ordinary income. Otherwise, ANCG is taxed at 15%. As illustrated in the following examples (also see Exhibit 1), the favorable tax treatment afforded to (the $24,000) 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).

- ***Example 1(a).*** If the total (non-ANCG) ordinary income included in taxable income ($6,550) plus the ANCG ($24,000) is less than the taxable income at the top of the 15% bracket ($30,650), then all of the ANCG ($24,000) is taxed at 5% in 2006–2007 (0% in 2008–2010).
- ***Example 1(b).*** If taxpayer's (non-ANCG) ordinary income included in taxable income ($40,000) exceeds the taxable income at the top of the 15% tax bracket ($30,650), then the ANCG ($24,000) is taxed at 15% from 2006 through 2010.
- ***Example 1(c).*** If the (non-ANCG) ordinary income included in taxable income ($20,000) is less

than the taxable income at the top of the 15% tax bracket ($30,650), and the ANCG ($24,000) is partially below and partially above the top of the 15% tax bracket, then only the part below the top of the 15% bracket ($10,650) is taxed at 5% (0% in 2008–2010) and the remainder ($13,350) is taxed at 15%.

Potential Tax Savings

The tax savings from the 0% rate depend upon what the applicable tax rate would otherwise have been. In Example 1(a), all of the $24,000 ANCG is tax-free. Compared to the 5% rate in 2006–2007, the 0% rate in 2008–2010 saves the taxpayer 5% or $1,200 ($24,000 x 5%).If a taxpayer can reduce the ANCG rate in 2008 to 2010 from 15% to 0%, the tax savings are $3,600 ($24,000 x 15%). Compared to the prospective 10% rate in 2011, if the $24,000 is NCG, the 0%-rate savings are $2,400 ($24,000 x 10% NCG rate). If the $24,000 is QDI, however, the savings depend upon the taxpayer's ordinary income tax bracket, because QDI loses favorable treatment in 2011. Any benefit is probably valuable to most retirees and children.

Probable Beneficiaries and Their Opportunities

Working individuals are unlikely to share the benefits. Those with low incomes, although commonly in the 15% tax bracket, often lack the wherewithal to save or generate ANCG. Middle-income workers usually straddle the 15% and 25% brackets, but initially save in tax-sheltered retirement accounts and only later in taxable accounts. High-income earners exceed the tax bracket threshold.

Prospective retirees. According to the U.S. Census Bureau, approximately 40 million individuals will be age 65 or older in 2010. In 2011, the first baby boomers turn 65. Those contemplating early retirement between 2008 and 2010 may be best positioned to exploit the 0% tax rates. Often new retirees choose the source of their retirement income and influence its amount and type by the timing and ordering of retirement savings withdrawals. With no preset base income (e.g., receiving no salary or being able to delay distributions from a retirement plan and Social Security), even formerly high-income individuals may be able to create a 15% tax bracket for three years and redeploy or reallocate assets.

- ***Tax-free draw-down from taxable accounts.*** A common retirement income draw-down (i.e., withdrawal) strategy is to liquidate taxable retirement accounts first and permit tax-deferred accounts to grow. By liquidating sufficient taxable capital assets to satisfy income needs, a retiree could shelter the capital gains from taxation. This strategy prolongs the deferral of tax-sheltered assets and delays the need for Social Security, potentially increasing the future benefits from both.

  Cash may be desired for other reasons, such as repaying debt or funding a side account. Most draw-down research concludes that annual withdrawals should be limited to approximately 4% of retirement asset values, plus the annual inflation rate, in order to avoid asset depletion before death. A side account supplements the reduced withdrawal amount when asset values decline during a market turndown.

- ***Portfolio management/tax-rate hedging.*** Upon retirement, many taxpayers reduce equity exposure and rebalance assets, usually those held inside a tax-deferred account (to minimize the tax burden). With the opportunity for tax-free capital gains, rebalancing may be accomplished throughout the portfolio, including the revision of asset-allocation percentages, the reallocation of individual stock risk (i.e., the sale of appreciated stock), or the substitution of more

appropriate asset classes (e.g., stock into real estate). Others may seize the opportunity to sell an appreciated asset to reset its basis to a higher amount, such as by selling it, realizing the tax-free gain, and repurchasing the same asset, or to hedge against expected higher capital gains rates.

- ***Miscellaneous asset sales.*** Sheltering nonrecurring capital gains from the sale of a business interest, rental property, or a principal residence in excess of the home-sale exclusion may be possible. For those holding appreciated company stock inside a company-sponsored retirement plan, retirement may be the optimum time to take a lump-sum distribution of company stock and generate capital gains from the net unrealized appreciation.

Retirees. Because many older retirees experienced the Great Depression, they often saved regularly in taxable accounts [before 401(k) plans existed], which now represent appreciated assets. According to the *2006 Investment Company Fact Book*, in 2005, 37% of households aged 65 or older owned mutual funds, mostly outside of a defined-contribution plan, and another 37% of equity investors owned only individual stocks.

Many older retirees live frugally on modest incomes, typically Social Security, pensions, diminishing traditional IRAs, and QDI. As documented below, the median and mean incomes for retirees qualify many of them for the 15% tax bracket. This income creates a base amount that potentially hampers their ability to fully capture the ANCG benefits. In some cases added income from asset sales increases the amount of taxable Social Security benefits, further increasing the base amount.

Such retirees' sheltering activities might be skewed toward building cash reserves (e.g., for medical expenses or assisted-care or nursing-home expenses), asset rebalancing (because many of them forgo active personal portfolio management, opt for buy-and-hold strategies, and use dividend-reinvestment plans resulting in portfolio imbalance), or tax-rate hedging.

Semiretirees. Semiretirees, who have delayed Social Security and retirement plan benefits, may have tax planning opportunities. Having retired early from a full-time, middle-income job and now working at a lower-paying endeavor, the semi-retiree may supplement lower (15% tax bracket) wages with assets from other taxable retirement savings. The wages create a base amount, however, limiting tax benefits.

Parents and their children. Because many children are in the 10% or 15% tax bracket, the gifting and income-shifting techniques for parents are well known. Parents may gift up to the annual exclusion (currently $12,000), presumably in appreciated stock, to each child over the age of 13 to avoid the "kiddie tax." The child receives the asset at its (lower) carryover basis, sells it at a gain, and pays the 5% capital gains tax. The same strategy is employed by other donors for other donees (e.g., grandparents and grandchildren).

Pursuant to TIPRA, after 2005 the kiddie tax applies to children under age 18. 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, such gifting (by parents or grandparents) and selling is best deferred until after the child's first semester of junior year, when a student's financial status is no longer evaluated. Optimally, these years would be 2008, 2009, or 2010. After the child's final semester, the child may start full-time employment and exceed the 15% tax bracket. For children not pursuing higher education or ineligible for financial aid, these timing issues are irrelevant.

Older parents who contemplate making gifts to older children may time their gifts so their children can take advantage of the aforementioned opportunities available to them in retirement.

Tax Savings Maximization

ANCG tax savings are maximized when retirement begins on December 31, because there will be no base amount on January 1 of the following year. Nevertheless, the amount of the savings depends on whether the retiree receives Social Security benefits.

Non–Social Security recipients. This category generally includes most prospective retirees, early retirees who are not yet eligible for or have elected to delay Social Security benefits, and the 12% of retirees age 65 or older who do not collect Social Security (*Congressional Research Service Report for Congress*, "Topics in Aging: Income and Poverty Among Older Americans in 2004"; hereafter the CRS Report). As previously noted, these individuals may be most likely to fall in the 15% tax bracket.

Because the 5% or 0% rate applies to ANCG in the 10% or 15% brackets only, generally the sum of the taxable income in these brackets represents the maximum amount of ANCG that can be sheltered tax-free each year. In 2006 the taxable income at the top of the 15% tax bracket is $30,650 for single filers and $61,300 for joint filers.

Assuming a 3% annual increase in the tax brackets, by 2010 these upward limits are projected to approach $34,500 and $69,000, respectively. If each taxpayer had the full 10% or 15% tax brackets available for ANCG (i.e., had no non-ANCG), the cumulative tax savings from 2008 to 2010 approximates $5,000 and $10,000, respectively (assuming 5% in 2007 versus 0% in 2008). With different rate assumptions, the savings could be greater.

Of course, assuming that taxpayers will have only ANCG is unrealistic. As Example 2(a) illustrates, in 2006 a single taxpayer under the age of 65 can have up to $8,450 of non-ANCG sheltered by the standard deduction ($5,150) and personal exemption ($3,300). Assuming a 3% annual increase in those deductions, by 2010 the possible non-ANCG approximates $9,500 for single filers, $19,000 for joint filers, and $10,900 and $21,300, respectively, for single and joint filers age 65 or older. Although these amounts are modest, these individuals are well positioned to manipulate their non-ANCG.

The amount of non-ANCG can exceed these limits if a taxpayer has deductions for adjusted gross income (AGI) or itemized deductions. As Example 2(b) illustrates, the full $14,300 of non-ANCG is sheltered by deductions for AGI ($1,000), itemized deductions ($10,000), and personal exemptions ($3,300), which provides the taxpayer with a non-ANCG limit greater than the standard deduction.

As Examples 2(c) and (d) in Exhibit 1 illustrate, if a taxpayer has income exclusively from ANCG, the various deductions provide the opportunity to increase the amount of ANCG beyond the standard deduction and personal exemptions.

Social Security recipients. According to the CRS Report, in 2004 approximately 35.2 million individuals were age 65 or older and 88% received Social Security. Their median income was approximately $15,000, which included about $10,400 in Social Security and $950 in income from assets (e.g., interest, dividends, rents, and royalties). Extending this data to couples, the median income was about $30,000 ($20,800 in Social Security; $1,900 in income from assets). Using a 3% annual increase, in 2006 the median incomes for individuals approximate $16,000 ($11,000 from Social Security; $1,000 in income from assets) and $32,000 for couples ($22,000 from Social Security; $2,000 in income from assets). Therefore, the tax bracket of Social Security recipients at the median income level is no higher than 15%.

Social Security recipients, too, can shelter non-ANCG up to at least the sum of the standard deduction

plus personal exemptions (in 2006, $9,700 for single filers and $18,900 for joint filers age 65 or older). As Example 3(a) in Exhibit 1 illustrates, a single taxpayer age 65 or over who receives income of $11,000 in Social Security and $5,000 in other non-ANCG is taxed on only $4,500 of the Social Security; all of the non-ANCG (including Social Security) is sheltered. This provides the opportunity to shelter all of the $23,500 in ANCG from capital gains taxes. Again, the ANCG amounts could be higher if the taxpayer had higher deductions for AGI or itemized deductions.

Unlike non–Social Security recipients, however, Social Security recipients cannot maximize their tax savings by increasing ANCG to the top of the 15% tax bracket ($30,650), because as ANCG increases, the amount of taxable Social Security might increase. [Depending on the amount of the taxpayer's provisional income (generally, AGI excluding Social Security, plus tax-exempt interest and 50% of Social Security), the amount of Social Security subject to taxation approximates 0%, 50%, or 85%.] As Example 3(b) in Exhibit 1 illustrates, an increase in ANCG (from $23,500 to $30,650) increases the amount of taxable Social Security (from $4,500 to $9,350) and the amount subject to regular tax rates (from $0 to $4,650), which reduces the benefit of ANCG.

Similarly, an increase in non-ANCG above the median income can increase the taxable amount of Social Security, also decreasing the ANCG eligible for sheltering. Example 3(c) in Exhibit 1 illustrates the outcome, assuming the higher estimated 2006 mean income per person of $25,300 ($11,300 from Social Security and $5,700 from income from assets). In this example, only $14,350 of ANCG is tax-free, and $8,800 of non-ANCG is taxed at regular rates.

In summary, tax planning is more complicated for Social Security recipients. To quickly estimate the minimum amount of ANCG that can be sheltered, assume that 85% of Social Security is taxable (therefore, additional ANCG will not increase it) and add it to other non-ANCG. Compare this total non-ANCG to the total deductions available to shelter it. Only if the total deductions exceed the total non-ANCG will the full 10% or 15% bracket be available for ANCG.

Tax-Bracket Management

Tax-bracket management uses traditional income/deduction shifting techniques. The goal in this case would be to minimize taxable income to ensure a taxpayer remains in the 15% tax bracket from 2008 through 2010. The examples below assume that, 1) without planning, the taxpayer would exceed the 15% bracket or be unable to fully exploit it, and 2) any ordinary income shifting between years would not increase the taxpayer's marginal tax bracket. Any loss in monetary value due to accelerated tax payments will be ignored; this should be more than offset by the tax savings from avoiding the higher ordinary rates without planning.

Anticipated income. For projected 2008–2010 income, the goal is to exclude it, accelerate it into 2006 and 2007, defer it to 2011, or convert it to ANCG. Many techniques pertinent to retirees reduce provisional income also, which reduces taxable Social Security benefits.

- Shelter wages (earned by semiretirees) by maximizing 401(k) plan or savings incentive match plan for employees (SIMPLE) IRA contributions.
- Monitor fixed-income (e.g., certificates of deposit) investment maturities; consider accelerated redemption. Use Series EE or I bonds to defer interest.
- Convert taxable interest-yielding investments into tax-free money-market funds or municipal bonds if the tax-free yields are comparable to taxable yields.
- Convert ordinary dividends from taxable money market funds to tax-free funds.
- Evaluate the desirability of real estate investment trusts (REIT), which generate nonqualified

dividends.
- Convert traditional IRAs (common for older retirees) with small balances to Roth IRAs to avoid minimum-distribution requirements.
- Eliminate the possibility of state income tax refunds by owing state income taxes.
- If contemplating a lump-sum distribution of appreciated company stock, determine its original cost basis, which is taxed as ordinary income upon distribution.

Anticipated deductions. For projected 2007 deductions, the goal is to defer them to 2008 (and possibly maximize them in 2008 if the results of the 2008 elections portend repeal of the favorable tax rates). These techniques include well-known "bunching strategies" for medical deductions (to exceed the 7.5% AGI floor) and charitable contributions, forgoing prepayment of fourth-quarter estimated state income tax payments, converting consumer loans into home equity loans to generate tax-deductible interest, and funding traditional IRAs to shelter wages.

Unanticipated income. Income surprises tend to disrupt even the most effective tax-bracket management.

- For taxpayers who itemize deductions, the tax benefit rule can trigger income from items such as reimbursements for medical expenses or property tax rebates for prior years.
- Usually the amount and character of mutual fund distributions are unknown until distribution. New fund purchases made before the year-end distribution date can exacerbate the problem.
- The consideration received by stockholders as a result of merger activity can generate ordinary income.

Capital Gain Considerations

Misreporting. The U.S. Government Accountability Office report GAO-06-603 (June 2006) offered the following conclusions: "[F]or tax year 2001, an estimated 38 percent of individual taxpayers who had securities transactions failed to accurately report their capital gains or losses from transactions (8.4 million out of 21.9 million taxpayers)." Of those taxpayers, 97% misreported stock and mutual fund transactions and 5% misreported bonds, options, or futures transactions; 64% underreported income and 33% overreported income; and 9% misreported the holding period.

Such potential errors seriously undermine the tax planning process. Upon audit, corrections to underreported income and holding periods can reduce the amount of ANCG eligible for favorable treatment.

Basis calculations. The GAO concluded that the errors occurred "often because [taxpayers] misreported the securities' cost basis." The most common reasons for misstatement were inadequate records, use of original cost basis instead of adjusted cost basis (e.g., failure to consider stock splits), inadequate understanding of basis calculation rules, erroneous calculations by tax return preparers, and incorrect broker-provided basis information.

Determining stock basis is relatively straightforward when one's records are complete. This task can be challenging, however, for those with inadequate records. Problems can be most pronounced for older taxpayers, especially those who made purchases many years ago, participated in dividend reinvestment plans (DRIP), held stocks that split or had spin-offs, or sold partial positions of their holdings. Equally difficult are calculations for those who purchased mutual funds and reinvested dividends before mutual fund companies began to provide basis data. Anecdotally, some older taxpayers elect to hold securities that were purchased years ago and whose investment characteristics changed and no longer meet their

investment objectives, simply because they do not know the basis. They rationalize that the securities will be bequeathed to heirs who will receive a step-up in basis anyway.

Recreating basis requires establishing the amount invested in a stock (usually original and additional purchases plus dividend reinvestments) and the allocation of costs resulting from stock splits and dividends and mergers and divestitures.

Frequently, the problematic task is determining the basis of stock from reinvested dividends. Financial websites are particularly helpful. For example, information at Yahoo Finance (online at finance.yahoo.com) provides historical dividends, stock prices, and stock-split information on a daily, weekly, or monthly basis. As an example, Exhibit 2 depicts a portion of the historical information for General Electric.

The information is listed chronologically and demonstrates the availability of daily prices, dividend, and stock-split information. Particularly useful for participants in the company's stock reinvestment program is the capability to display only dividends and stock splits.

Another useful feature of this and other financial websites is the ability to download data to an Excel spreadsheet. Once the information is downloaded, rows can be inserted to show initial and subsequent purchases using that dividend and price information to identify the shares purchased and their specific basis. This is particularly helpful for investments that vary widely in price over time.

Establishing a company history is essential for stock acquired via spin-offs, stock dividends, and stock as payment for mergers. Exhibit 3 shows the extensive, complex lineage of AT&T Corp., stock widely held by today's retirees. The exhibit shows the initial divesture of AT&T Corp. on January 1, 1984, and the subsequent divesture or spin-offs and the new corporations. The percentages shown in each block are the percentages of the parent's total cost basis allocated to the new corporation. The lineage chart provides the information needed to research stock basis. A company's website, typically under "investor relations," generally presents basis allocation data, often with online or downloadable worksheets and examples. Brokerage firms often provide similar data to their clients. For example, the SBC/AT&T investor relations website (www.att.com/ir) offers worksheets to determine the cost basis of shares of AT&T and their various spin-offs.

Recreated records must be sufficient to withstand audit and to identify per-share costs and holding-period data in order for stock sales to be tax-efficient. Unless the basis of stock sold is specifically identified, the default basis is calculated by the first-in, first-out method (FIFO). Mutual funds are treated similarly, with an additional option to use average cost.

Capital loss management. Taxpayers should plan to use tax-loss carryforwards prior to 2008, so that they will not offset tax-free capital gains in 2008–2010.

Other Considerations and Risks

Possible costs. Tax planning is too inexact to predict whether the tax savings will outweigh the potential tax planning/preparation costs (e.g., basis calculations) or transaction costs of liquidating assets. Will some ANCG be taxed at 15% rather than 0%? Even if ANCG is excluded for federal purposes, will the accelerated gain recognition increase state income taxes? Planning is geared toward 2008—a presidential election year, which historically brings volatility to securities markets. Deferring 2006–2007 unrealized gains to 2008 may risk a decline.

Basis step-up. Will elderly taxpayers balk at liquidating securities positions when, upon their death, their heirs receive them income tax free with a step-up in basis at no cost (depending on the size of the estate and prospective estate tax changes in 2011)?

Income-based assistance. Sometimes senior citizens receive income-based assistance (e.g., state-financed drug or property-tax relief programs). Added ANCG could disqualify them from such programs.

Medicaid planning. Gifting has tax advantages, but these transfers could delay Medicaid eligibility. Because the states want to ensure that individuals do not qualify for Medicaid by purposely transferring their assets to others, they now review the propriety of transfers made during the last five years (instead of three).

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