TAX LETTER

Year-end strategies: taxpayer with appreciated capital assets

For many taxpayers, two important changes having capital gains implications will go into effect by 2008. The first is the zero percent tax rate on capital gains that will apply to taxpayers in the lowest two tax brackets. The second is the extension from age 18 to 24 for kiddie tax which could reach more children than before. This *letter* looks at the year-end planning opportunities of these two changes.

Zero capital gains rate for some. An individual taxpayer's net capital gain, exclude collectibles or recaptured gain, is taxed at a maximum rate of 15%. However, if the net capital gain be taxed at a rate below 25% if it were ordinary income, then, the tax rate for the net capital gain is 5% rate for 2007, and will be zero percent from 2008 to 2010. (Code Sec. 1(h)(1)(B), Code Sec.1(h)(1)(C))

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 now) if that tax is higher than the tax the child would otherwise pay on it. (Code Sec. 1(g)) For 2007, a child is subject to the kiddie if he or she has not attained age 18 before the close of the tax year; at least one 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. (Code Sec. 1(g)(2)(A))

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 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))

Example #1. A young or low taxable income 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 yearend, 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.

Example #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.

> **Illustration :** The Jones will be in the 28% bracket this year and next year. Junior, their 22-year-old son, has finished college and needs cash to start a business. The Jones' assets include stock they bought for $5,000 and which is now worth $20,000. If the Jones sell the stock this year to give Junior 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 Junior's top dollars will be taxed at maximum 15%). If they haven't made other gifts to Junior during 2007, their gift of stock also will be gift-tax-free. That's because the annual gift tax exclusion is $12,000 for each Donor to each Donee ($24,000 for married couples who split gifts).

Example #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 then sell the securities near tax free or tax free in 2008 to 2010, because their young adult children will not be subject to the Kiddie Tax Reules and they would be in the lower tax brackets. 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 possible 0% capital gains rate. If the child is 19 to 24 years old and a full time student, he or she should sell it this year to take advantage of the 5% rate. If he or she waits till next year, heor she may have to pay at the 15% rate for the gain.

Example #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).