The Wealth Counselor
A monthly newsletter for wealth planning professionals

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My practice is people oriented and exclusively devoted to estate planning, estate and trust administration, estate and trust litigation, asset protection and business planning. My newsletter highlights wealth planning issues designed as helpful insights to your practice

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Planning for the New "Zero Percent" Tax Bracket

This issue of The Wealth Counselor addresses a law change that is important to all wealth planning professionals and their clients. Beginning January 1, 2008 and continuing through at least 2010, a zero tax rate may apply to long-term capital gain and dividend income that would otherwise be taxed at the regular 15% and/or 10% rates. The new zero tax rate is available to the extent that the taxpayer's other taxable income minus exemptions and deductions is less than a specified amount.

The new zero tax rate thus creates the opportunity for eligible clients to sell certain appreciated assets at no tax cost. By coordinating their efforts to ensure that clients take advantage of this opportunity, the planning team can preserve more of the client's investible assets or provide resources to fund implementation of the planning team's recommendations.

The Zero Tax Rate
The zero tax rate applies to eligible individual taxpayers who have "adjusted net capital gain." Adjusted net capital gain is the sum of:

Net capital gain (generally the excess of net long-term capital gains other than collectibles gain, gain taxed on sales of certain small business stock under IRC Sec. 1202, and unrecaptured IRC Sec. 1250 gain over net short-term capital losses, subject to certain limitations),

plus

Qualified dividend income (generally dividend income from domestic corporations and qualified foreign corporations, including dividends from U.S. possessions corporations and corporations eligible for benefits of a comprehensive income tax treaty with the U.S. that includes an exchange of information program; dividends that are not qualified include dividends from foreign investment companies, dividends from stock held for short periods, and payments in lieu of dividends).

Planning Tip: The zero tax rate does not apply to net capital gains and qualified dividend income of non-grantor trusts, estates, and C corporations.

Planning Tip: The zero tax rate does not apply to collectibles gain or gain taxed on sales of certain small business stock under IRC Sec. 1202 (both taxed at a maximum rate of 28%), or to unrecaptured IRC Sec. 1250 gain (taxed at a maximum rate of 25%).

Who Gets the Zero Tax Rate?
For tax years beginning January 1, 2008, the zero tax applies to individuals' adjusted net capital gain to the extent that it does not exceed:

the threshold for the taxpayer's 25% income tax bracket, minus

the taxpayer's taxable income other than adjusted net capital gain.

Planning Tip: Stated another way, the zero rate only applies to adjusted net capital gain to the extent the taxpayer's other taxable income minus exemptions and deductions is below the bottom of the 25% income tax bracket for that taxpayer.

For 2008, the threshold for the 25% income tax rate is:

- $32,550 for single taxpayers and married taxpayers filing separate returns;
- $65,100 for married taxpayers filing joint returns and surviving spouses; and
- $43,650 for heads of households.

Thus, taxpayers whose ordinary income plus net capital gains and dividend income not included in adjusted net capital gain exceeds their respective 25% income tax thresholds will not be eligible for the zero rate. Conversely, if their 2008 ordinary income plus net capital gains and dividend income not included in adjusted net capital gain is less than their respective 25% income tax threshold, the zero tax rate applies.

Examples
Example 1. Tom and Mary Taxpayer file jointly and have taxable income of $60,000 in 2008, comprised of $50,000 of ordinary income and $10,000 of

adjusted net capital gain. Since the Taxpayer's ordinary income is less than the 25% income tax threshold, the zero tax rate would apply to all of their $10,000 adjusted net capital gain.

Example 2. The Taxpayers have taxable income of $75,000 in 2008, comprised of $50,000 of ordinary income and $25,000 of adjusted net capital gain. In this case, $15,100 (the difference between their 25% income tax threshold and their ordinary income of $50,000) would be subject to the zero tax rate, and the balance, $9,900 ($75,000 - $50,000 - $15,100), would be subject to the 15% rate.

Example 3. The Taxpayers have taxable income of $75,000 in 2008, comprised of $70,000 of ordinary income and $5,000 of adjusted net capital gain. Since their ordinary income exceeds the 25% income tax threshold, none of their adjusted net capital gain would be subject to the zero tax rate - all $5,000 would be subject to the 15% rate.

Planning Tip: To the extent taxpayers have a gap between (1) their ordinary income plus net capital gains and dividend income not included in adjusted net capital gain and (2) their 25% income tax threshold, that gap can be taken up by adjusted net capital gain subject to the zero tax rate, even if they have income that is subject to higher rates.

Example 4. Frank and Susan Taxpayor file a joint return with adjusted gross income (AGI) of $225,000, consisting of $105,000 of wages, plus $120,000 of adjusted net capital gain. For 2008, the Taxpayors claim a total of $55,000 in personal exemptions and itemized deductions, resulting in taxable income of $170,000 ($225,000 AGI minus $55,000 in deductions). The zero rate applies to $15,100 of the Taxpayors' adjusted net capital gain calculated using the formula above as follows:

the $65,100 maximum threshold for joint filers for 2008, minus

their $50,000 of regular taxable income ($170,000 taxable income minus $120,000 of adjusted net capital gain).

The $104,900 balance of the Taxpayors' adjusted net capital gain ($120,000 minus $15,100) will be subject to the 15% rate.

Planning Tip: 2008 year-end tax planning should pay careful attention to opportunities to use income and deduction timing to make clients eligible for the zero tax rate.

Application of the "Kiddie Tax"
Also new for 2008 is that the "kiddie tax" (which applies to the child at his or her parents' highest marginal rate on the child's unearned income over $1,800) affects many more children.

For tax years before 2008, the kiddie tax applied only to children under 14. Effective January 1, 2008, a child is subject to the kiddie tax if he or she is (a) under 18; or (b) age 18, or a full-time student and 19-23 years old, and his or her earned income constitutes one-half or less of that child's support.

Planning Tip: If the earned income of a child age 18, or age 19-23 if a full-time student, exceeds one-half his or her support, the kiddie tax rules will not apply and the child will be able to take advantage of the zero rate for long-term capital gains and qualified dividends.

Conclusion
The zero tax rate for adjusted net capital gains presents a significant opportunity for those clients whose ordinary income is less than their 25% income tax rate threshold (no matter how high their other income), as well as clients with college-aged children whose earned income is greater than one-half of their support. Like so many other areas, this is one where the client's planning team needs to work together to ensure that clients pay the least amount of tax possible while still accomplishing personal goals and objectives. Paying no tax on eligible adjusted net capital gains can provide additional investible assets or increased liquidity to fund the planning team's recommendations.

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