

Capital Gains Year-End Planning: Still Time to Make a Difference

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Year-end tax planning for capital gains and losses becomes more complicated as Congress changes capital gains rates from year to year. Certain techniques have always made sense.

Selling stock at a loss was (and still is) useful to offset capital gains realized during the year, as well as to offset other taxable income.

Donating appreciated property to charity effectively reduces taxes because the donor can deduct the fair market value of the property without recognizing any gain on the appreciation. This benefit is still available, although the use of fair market value was cut back in 2006.

Lower rates through 2010

The favorable tax rates for capital gains and dividends continue through 2010. For individuals in the 25 percent (or higher) income tax bracket, long-term capital gains and qualified dividends are taxed at a maximum of 15 percent. For individuals in the 10 or 15 percent income tax brackets, gains are taxed at 5 percent through 2007 and at zero percent for 2008 through 2010. At the end of 2010, these rates revert to the higher 2002 tax rates unless Congress extends them or makes them permanent.

Long-term capital gains are realized on stock that is held for more than one year. Stock held for one year or less generates short-term capital gains. Short-term gains are taxed at ordinary income rates, not at the reduced capital gains rate. The reduced rates also apply to net capital gains, which are the excess of net long-term gains over net short-term losses. Excess net capital losses can offset up to \$3,000 of ordinary income (which can be taxed at rates as high as 35 percent), with the excess losses being carried forward.

Net short-term capital gains will offset net long-term capital losses. If the excess is short-term gain, it will be taxed at ordinary income rates, like other short-term capital gains. If you have realized short-term gains and have unrealized long-term losses, you may want to sell the long-term assets so that you can use the losses to offset the short-term gains.

These preferential rates were set to expire at the end of 2008, but Congress extended them until 2010 in the Tax Increase Prevention and Reconciliation Act of 2005. There is no telling whether Congress will take further action. Many experts believe these low rates will not be seen again for a long time and that capital gain planning over the next several years is critical.

Qualified dividends

Qualified dividends are dividends paid by a domestic corporation (public or private) or a qualified foreign corporation on stock that is held for at least 60 days during a specified period. While it is hard to know whether stock will appreciate, many stocks and mutual funds have a history of paying dividends on a consistent basis. To increase your current income taxed at the 15 percent rate, consider purchasing dividend-paying stocks. This can be done at any time but is worth considering at the end of the year.

If you have stocks that have declined in value, this may be a good time to sell them. Not only will the losses offset other capital gains, but the proceeds can be used to buy dividend-paying stocks.

Taxable income cut-offs

If your income level may be close to the cut-off for the 15 percent income tax rate, it would be worthwhile to look at how you can take advantage of the zero percent tax rate that will apply to capital gains in 2008. One technique would be to accelerate income into 2007 to qualify for the zero rate in 2008. If you expect to qualify for the zero percent rate in 2008, you may want to delay selling long-term capital assets until 2008, when you can take advantage of the zero rate. However, if you expect the value of the asset to decline, it may not be a good idea to delay the sale.

Tax-free exchanges

Ordinarily, you would prefer to avoid recognizing any gain on a sale or exchange if you can accomplish the same transaction tax-free. An example would be a like-kind exchange of business property. But under the current system, a tax-free transaction, followed ultimately by a taxable sale after 2010, may result in your having to recognize a greater amount of capital gains income than if you had sold the property for a taxable gain while the maximum capital gains rate was 15 percent. So it may be worthwhile to consider a taxable sale of the property before the 15 percent rates expire.

Foreign stock

Dividends on foreign stock can qualify for preferential rates if the stock is traded on an established U.S. securities market, the corporation is incorporated in a U.S. possession, or if certain treaty requirements are met. The IRS has issued guidance on countries that meet the treaty requirements. If you want to invest in foreign stocks that pay dividends, this guidance can direct you to countries to consider.

The foreign tax credit has limitations to prevent taxpayers from using the credit to reduce taxes on U.S. income. The maximum credit is based in part on the taxpayer's foreign source income. Foreign capital gain must be reduced by the taxes saved from the special rates and must be offset by domestic source capital losses. These rules now apply to dividends as well as capital gains, since both have special rates. So, these rules may reduce the usefulness of the foreign tax credit.

Alternative minimum tax

The reduced capital gains rates apply for both regular tax liability and the alternative minimum tax. Thus, the lower rates are not a tax preference item for the AMT. For purposes of the AMT, a

noncorporate taxpayer's capital gains (including qualified dividends) are computed in the same manner as for the regular income tax.

If you need any assistance in reviewing how your investment portfolio might benefit from year-end tax planning, Wipfli is ready to help.

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