

Zero Tax on Long-term Capital Gain and Dividend Income



Beginning this year and continuing through at least 2010, a zero tax rate applies to most long-term capital gain and dividend income that would otherwise be taxed at the regular 15% rate and/or the regular 10% rate (last year, a 5% rate applied to such income). Is this true investor nirvana? As this article explains, the answer is “yes,” not only for lower-bracket individuals but also, surprisingly, for some whose top dollars are taxed well in excess of 15%. The amount of income taxed at 0% depends on the interplay between an individual's filing status, his taxable income, and how much of that taxable income consists of long-term capital gain and dividends.

Where the zero tax rate applies. The zero tax rate is available only for a non-corporate taxpayer who has a net capital gain and/or qualified dividend income. Net capital gain generally is the excess of net long-term capital gains over net short-term capital losses, subject to certain netting rules. But the zero tax rate doesn't apply to collectibles gain or Code Sec. 1202 gain (gain taxed on sales of certain small business stock), both taxed at a maximum rate of 28%, or to unrecaptured Code Sec. 1250 gain, which is taxed at a maximum rate of 25%. (Code Sec. 1(h)(1) through Code Sec. 1(h)(6))

Qualified dividend income generally is dividend income received from domestic corporations and qualified foreign corporations (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, but not passive foreign investment companies). (Code Sec. 1(h)(11)(B)(i)) Dividends paid by other foreign corporations also are qualified if paid on stock or ADRs readily tradable on an established U.S. securities market. (Code Sec. 1(h)(11)(C)) There are numerous exceptions, such as for stock held for short periods, and payments in lieu of dividends.

For tax years beginning after 2007, a 0% tax applies to so much of the adjusted net capital gain (net capital gain reduced by collectibles gain, Code Sec. 1202 gain, or unrecaptured Code Sec. 1250 gain, and increased by qualified dividend income)—or, if less, taxable income—that doesn't exceed the excess (if any) of:

- (1) the amount of taxable income that would be taxed at a rate below 25% (without taking the special capital gains rates into account), over

- 2) taxable income reduced by the adjusted net capital gain. (Code Sec. 1(h)(1)(B)).

The balance of the taxpayer's adjusted net capital gain is taxed at 15%. (Code Sec. 1(h)(1)(C)).

Observation: The amount of taxable income that would be taxed at the regular tax rate below 25% (in (1), above) is the amount that would be taxed at 10% or 15%, since those rates are the only regular tax rates that are below 25%. As a result, the amount at (1) for a particular taxpayer can't exceed the “top” (also known as the break-point) of the 15% rate bracket for his filing status. The amount at (1) also marks the maximum tax-free amount of adjusted net capital gain. For 2008, the amount 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.

The amount at (2) is taxable income other than adjusted net capital gain, namely: ordinary income (e.g., wages and interest income) plus net short-term capital gain, plus any collectibles gain, Code Sec. 1202 gain, or unrecaptured Code Sec. 1250 gain.

Simplified formula. A short-hand way to express the amount of a taxpayer's adjusted net capital gain taxed at 0% is: (1) the break-point amount—our term for the “top” or break-point of the 15% bracket (for 2008 it's \$32,550, \$65,100, or \$43,650 depending on filing status), minus (2) regular taxable income (our term for taxable income reduced by adjusted net capital gain).

Illustration 1: Jeff and Jane Kane are “coupon clippers” whose taxable income of \$65,100 for 2008 consists entirely of qualified dividends. The break-point amount for joint filers is \$65,100, and the Kanes have no regular taxable income, so the 0% tax rate applies to all of their taxable income.

Observation: Most taxpayers with adjusted net capital gain also will have other taxable income. The 0% tax rate may apply to all, some or none of their adjusted net capital gain, depending on whether their taxable income (regular taxable income and adjusted net capital gain) is within the first two tax brackets, and how much regular taxable income they have.

Illustration 2: John and Jane Doe file jointly and have taxable income of \$65,000 in 2008, \$55,000 of (over)

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which is ordinary income and \$10,000 of which is adjusted net capital gain consisting of long-term capital gain on the sale of stocks and qualified dividend income. The break-point amount for joint filers is \$65,100 and the Does' regular taxable income is \$55,000, so the 0% tax rate would apply for up to \$10,100 of adjusted net capital gain (\$65,100 - \$55,000). Because the Does' adjusted net capital gain of \$10,000 is less \$10,100, all of it qualifies for the 0% tax rate.

Illustration 3: Fred Able is a single taxpayer with \$38,000 of taxable income in 2008, \$32,000 of which is ordinary income and \$6,000 of which is adjusted net capital gain consisting of qualified dividend income. For 2008, the break-point amount for single taxpayers is \$32,550, and Able's regular taxable income is \$32,000, so the 0% tax rate applies to only \$550 of his qualified dividend income (\$32,550 - \$32,000). The \$5,450 balance of his qualified dividend income (\$6,000 - \$550) is taxed at 15%.

Observation: Note that if a taxpayer's regular taxable income is *equal to or more than* the break-point amount, none of his dividend income will be eligible for the 0% tax rate.

Illustration 4: Same facts as in *Illustration (3)* except that Able's \$38,000 of taxable income for 2008 consists of \$34,000 of ordinary income and \$4,000 of qualified dividend income. Here, none of the dividend income would qualify for the 0% rate, because Fred's regular taxable income of \$34,000 exceeds the \$32,550 break-point amount for a single taxpayer.

Observation: As *Illustrations (3) and (4)* demonstrate, regular taxable income effectively "absorbs" the 0% rate before it can actually be applied to adjusted net capital gain. But where the break-point amount exceeds regular taxable income, the 0% rate applies to the taxpayer's adjusted net capital gain to the extent of that excess, regardless of whether he has additional income taxable at higher rates (or not taxable at all), and regardless of whether his taxable income has been achieved as a result of allowable deductions. In other words, the 0% rate is potentially available to all taxpayers with adjusted net capital gain.

Illustration 5: For 2008, Hal and Harriet Ford, married taxpayers who file a joint return, have adjusted gross income (AGI) of \$255,000, consisting of \$115,000

of wages, plus \$140,000 of adjusted net capital gain consisting of long-term capital gain from the sale of stock. For 2008, the Fords claim a total of \$95,000 in personal exemptions and itemized deductions for real estate taxes, mortgage interest, and charitable donations, resulting in taxable income for the year of \$160,000 (\$255,000 AGI - \$95,000 in deductions). The 0% tax rate applies to \$45,100 of the Fords' adjusted net capital gain, which is:

- ◆ The \$65,100 break-point amount for joint filers for 2008, minus
- ◆ Their \$20,000 of regular taxable income (\$160,000 taxable income minus \$140,000 of adjusted net capital gain). The \$94,900 balance of the Fords' adjusted net capital gain (\$140,000 - \$45,100) is taxed at 15%.

Who can't benefit. Most children who are subject to the kiddie tax won't benefit from the 0% tax rate if their parents are in the higher brackets. For 2008, a child subject to the kiddie tax pays tax at his or her parents' highest marginal rate on the child's unearned income over \$1,800 if that tax is higher than the tax the child would otherwise pay on it. (Code Sec. 1(g)) Under stricter rules that apply beginning this year, a child is subject to the kiddie tax if (a) he or she has not attained age 18 before the close of the tax year; or (b) is age 18, or is a full time student over age 18 but under age 24, and his or her earned income doesn't exceed one-half of the amount of their support. (Code Sec. 1(g)(2)(A))

The stricter rules were designed to discourage families from gifting appreciated stock, mutual-fund shares, and other securities to their low-income, young-adult children who (if no longer subject to the kiddie tax rules and if in one of the two lowest tax brackets) could then sell the securities tax-free under the 0% tax rate rule. The stricter kiddie tax rules eliminate the opportunity to do this in many cases. However, if the earned income of a child over age 18, or age 19-23 if a full-time student, exceeds one-half his or her support, the kiddie tax rules won't apply and he or she will be able to take advantage of the 0% rate for long term capital gains and qualified dividends.

We hope you find this information helpful. If you have any questions or want to schedule an appointment to discuss this in detail, please feel free to contact us..

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