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The Tax Relief Act and Capital Gains Taxes

By Michael Kitces

Ending an extensive period of tax uncertainty—at least for a little while—the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Tax Relief Act) was signed into law by President Obama on December 17, 2010. The legislation, a compromise between the Democrats and Republicans on, among other areas, tax brackets, extension of various tax expenditures, estate taxation, and unemployment benefits, brought a great deal of clarification about the tax situation for 2011—and just in time, too, because it came only two weeks before the end of 2010.

Although CPA financial planners will be interested in a number of the planning provisions of the new legislation, one of the areas discussed more often is the effect of the Tax Relief Act on capital gains taxes.

Background

Prior to the implementation of the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) in 2003, the long-term capital gains maximum tax rate was 20%, or 10% for long-term capital gains' income falling in the bottom two tax brackets (that is, in the 10% or 15% ordinary income tax brackets). With JGTRRA, the 20% and 10% rates were reduced to 15% and 5% rates, respectively. In addition, the 5% rate was scheduled to be reduced to 0% in 2008 (that is, the tax rate applicable to long-term capital gains falling within the bottom two tax brackets in 2008 would be 0%). Under the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), enacted with President Bush's signature on May 17, 2006, these preferential long-term capital gains tax rates were extended to expire at the end of 2010 instead of December 2008.

If the current long-term capital gains tax rate provisions of JGTRRA and TIPRA had expired at the end of 2010, the rates would have reverted to pre-JGTRRA levels of 20% (and 10% for those in the lowest tax bracket), with the reinstatement of special, ultra long-term rates of 18% and 8% rates for 5+ year holding periods for property purchased after January 1, 2001. However, with the enactment of the Tax Relief Act, the current 15% and 0% tax rates for long-term capital gains remain in place, extended until the end of 2012 at an estimated cost of \$25.9 billion.

Planning Implications

With the risk of a significant rise in long-term capital gains tax rates (for example, paying taxes of \$20,000 [20%] per \$100,000 of gains is a 33% increase in taxes due over just a \$15,000 liability [a 15% rate]), many

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planners and clients have been exploring proactive steps to fend off the potential impact of higher taxes.

The most popular strategy was harvesting gains before the end of the year, selling a security with a gain, reporting the gain, and then repurchasing the original security shortly thereafter (no requirement to hold something else for 30 days in this case because the "wash sale" rules only apply to harvesting losses, not gains).

The idea was fairly straightforward. If the property was going to be sold in the next few years anyway, pay taxes at 15% rates now, rather than deferring gains into future 20% tax rates.

Given that tax rates are now scheduled to remain in place for at least the next two years, the urgency of harvesting gains is somewhat diminished, at least in the near term. If property was going to be sold in 2012 anyway, it generally still pays to defer the income and the taxes until the future, allowing the time value of money to work in the client's favor with tax rates that are no longer scheduled to change next year. If property is going to be sold in 2013 or beyond, when the rates are scheduled to go higher, it still pays to wait a little (at least until sometime in 2012), both for the value of another year of tax deferral and because it is always possible rates will be extended further when the time comes.

Notably, though, the risk of higher long-term capital gains tax rates still makes gains harvesting appealing for gains that may have been recognized in 2013 or beyond. In addition, it is still a disincentive for deliberate steps for significant tax deferral, such as installment sales that recognize gains ratably over a period of several years (with whatever tax rates apply in those years).

Clients completing significant sales, including possibly and perhaps especially a business, may wish to be cautious about stretching income and payment out over a large number of years because the value of tax deferral may be outweighed by higher tax rates. Receiving shorter-term lump sum payments or simply electing out of installment sale treatment should at least be considered.

On the other hand, for clients who are in the lowest two tax brackets—and, therefore, eligible for the 0% long-term capital gains tax rate—harvesting gains may be especially appealing, regardless of when the property was going to otherwise be sold. Even if tax rates remain level, 0% taxation is still 0% taxation! Accordingly, clients in this tax bracket can essentially sell property, report a capital gain, purchase the security back, and reset their cost basis to a higher level to reduce future taxation, yet pay 0% capital gains tax rates in the process. They essentially get a "free" step-up in basis.

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Of course, in reality, because the income reported from capital gains is still above-the-line income and affects adjusted gross income, the net tax impact often is not quite \$0 because 0% capital gains income may still cause some phaseouts and inclusion of Social Security benefits. Nonetheless, the effective tax rate is still so low that harvesting gains for clients eligible for 0% tax rates is highly appealing any and every year it is available.

In addition, due to the appeal of harvesting gains in current or future years if 0% tax rates are available and the ongoing “risk” of higher taxation beyond 2012, planners should also be very cautious about harvesting capital losses in the current environment. In the traditional tax planning world, harvesting losses is a favorable way to accelerate the time value of money by claiming a tax loss immediately and reporting the gain when the security recovers at a more distant point in the future. However, in reality, the economic value of tax loss harvesting is often extremely modest, and in a rising tax rate environment, it can actually be harmful.

Losses that are harvested now and offset against current gains cannot be used against gains in the future when tax rates are higher; thus, harvesting a loss today (and resetting the cost basis lower) and creating an offsetting gain in the future when the value recovers could generate a loss at today's lower rates and a gain at future higher rates—a rather adverse negative tax arbitrage. This may be especially damaging if the loss applies against a 0% capital gains tax rate, while the future gain is anything higher than 0%.

Similarly, planners may also wish to be cautious about harvesting “excess” losses that will knowingly be carried forward into future years. The requirement that carryforward losses automatically apply against gains may unwittingly “force” clients to use carryforward losses against 0% or low tax rate capital gains, instead of simply preserving the loss by keeping the security and selling it for a loss—or less of a gain—in the future.

In the end, the current tax environment—with favorable capital gains tax rates extended through 2012, but at risk to rise much higher thereafter—creates significant planning opportunities for clients. However, proactive planning and communication is necessary because the proper planning approach for a potential rising tax rate environment (that is, accelerate and harvest the gains while deferring and avoiding recognition of the losses) is not only unfamiliar to clients, but the exact opposite of what most have traditionally done in the past. ■

Best Planning Ideas: Daniel Rubin

Daniel S. Rubin, JD, LL.M. (Taxation), is a partner in the Trusts and Estates and Asset Protection practices of Moses & Singer LLP. Along with several other experts, he recently participated in the “Best Planning Ideas Panel” at the AICPA’s Personal Financial Planning (PFP) Conference in Las Vegas. Rubin sees several trends in estate planning, including the newly increased federal gift tax exemption, credit shelter trusts, and the use of permanent trusts for descendants for asset protection purposes. Here are his “best planning ideas.”

Gift Tax Exemption

Regarding the gift tax exemption, Rubin stated, “Now is a great time for gifting; asset values are relatively low, interest rates that factor into various leveraging techniques remain low, and Grantor Retained Annuity Trusts are still around, almost to everyone’s surprise.”

The historic exemption from the gift tax was \$1 million. Now, Rubin said, it’s \$5 million, and that only exists this year and for 2012. On January 1, 2013, the exemption will again

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be \$1 million. Rubin advised that it's always good to make gifts earlier rather than later in order to generate maximum growth.

One key question: Will more states enact gift taxes?

"Only two have them now," he said, "but my best guess is that states will start enacting gift taxes, which are a kind of backstop to the estate tax. In my mind, it makes sense for cash-strapped states to maintain the integrity of their estate taxes with gift taxes."

Reasons for Credit Shelter Trusts

Rubin said one major question during the "Best Ideas" session was whether portability, under the new tax law, removes the need for credit shelter trusts. *Portability* dictates that, with a special election, a surviving spouse can use any estate tax exemption that was left unused by his or her deceased spouse.

Although attractive in concept, he said, "portability is not a planning tool. At least seven good reasons exist for why estate planners should not rely on portability, but should instead continue to utilize credit shelter trusts." These include the following:

1. Portability is here only temporarily, and it requires both the predeceased spouse and the surviving spouse to die on or before December 31, 2012. If only one spouse dies on or before December 31, 2012, his or her unused exemption may be ported to the survivor, but unless the survivor uses the ported exemption by making a gift on or before December 31, 2012, the ported exemption will disappear when the law sunsets on December 31, 2012 (unless the surviving spouse also died on or before December 31, 2012).
2. Portability governs only the federal estate tax exemption and not the state estate tax exemption. Although only 17 states and the District of Columbia currently impose state estate taxes, it seems likely that more states will enact such taxes.
3. The portability amount is not indexed for inflation and, even if it were, it would likely not keep pace with actual appreciation.
4. Portability requires an affirmative election without any opportunity for redress in the event of a failure to make a timely election. The election is likely to be required to be made on an estate tax return, which might not otherwise be required and which might unnecessarily expose matters to scrutiny by the IRS.
5. The generation-skipping transfer lifetime exemption is not portable, and those estates large enough to benefit from portability also are likely large enough to benefit from generation-skipping transfer tax planning.
6. Portability is only available for the estate tax exemption of the last predeceased spouse. As a result, relying on portability will waste the predeceased spouse's unused exemption if the surviving spouse remarries and then outlives his or her new spouse.
7. Portability only provides an estate tax benefit. Trusts, including credit shelter trusts, serve many valuable purposes, including asset protection, investment management, and intelligent distribution of assets.

Self-Settled Spendthrift or Asset Protection Trusts

Another trend Rubin sees is the transferring of assets to trusts for combined estate tax and asset protection planning purposes.

“People remain concerned about the potential of being sued and want to protect themselves regarding future lawsuits. Historically, their options were limited if they wanted to protect assets, but still retain the potential to use those assets.” That began to change in 1997, he noted, when Alaska became the first state to allow for *self-settled spendthrift trusts* or *asset protection trusts*, where property could be protected from future creditors, including future former spouses. They are now permitted by law in 11 states.

“Over time, this will become the general law of the land,” he said, adding that these trusts can be set up by individuals who have no creditors and if the individual doesn’t live in one of the 11 states. He added that these trusts make the most sense only if there is at least \$500,000 in cash or other property to put in.

Trustee Trends

The next decade will see changes regarding trusts using financial institutions as trustees.

“Historically when one established a trust with an institutional trustee, it meant your client would need to invest the trust fund with that institution. In some ways, if you were a personal financial planner, you’d no longer have your client. In recent years, certain states enacted directed trustee statutes, which allow a third party to direct the trustee with regard to investment of the trust fund. Here, the fee to the institution is a low fixed fee instead of a fee based on the percentage of the trust fund.”

“Directed trusteeship,” he explained, “shifts responsibility and risk off the institution, and saves on fees. The fees of a directed trustee will almost certainly be significantly lower than those of non-directed institutional trustees, which based their fees upon assets under management.”

Permanent trusts for children, which mandate distributions at certain ages for better asset protection and passing of assets, also will likely change. Rubin cited the example of trusts that typically require distributions to children at ages 25, 30, and 35, dividing the inheritance and allowing for balanced payout at increasingly mature ages.

“The issue with this form of disposition is that a parent can’t know his or her child’s circumstances at those ages. They could go through a divorce at 25, get sued at 30, or go through a personal bankruptcy at 35. Why would a parent want to take a chance that the money would then be lost to a creditor?”

He said the new trend, “is to create a permanent trust for children and, when the children attain a certain age of maturity, give them leverage over the trustee through an authority to fire the trustee and replace this person with a more accommodating one. Clients like the idea once it’s explained to them, especially younger ones.”

This, Rubin reasons, may be because younger clients tend to understand more fully the litigious nature of modern society or the likelihood of a modern marriage ending in divorce. ■

Best Planning Ideas Panel Materials

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