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Capital Gains Paradox

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Have capital gains become a threatened and endangered species?

Can the size of future estates be projected accurately? If an estate's assets appreciate in value, which capital gains tax breaks apply? Which of those tax breaks will still be available five years from now? What does it all mean?

> ***The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital... the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth in the economy.***
> *—John F. Kennedy*

The paradox of establishing financial plans that can exploit future gains and current tax rules is that there may be no gains, and the tax breaks that apply now may be gone by the time they are needed.

Let's review what we know and how best to plan ahead.

Key Rules Now

SHORT-TERM GAINS: Appreciation on assets held less than one year is taxed as ordinary income. Examples: A married couple filing a joint tax return and earning more than $379,150 in 2011 is in the 35% tax bracket, and their short-term capital gains would be taxed at 35%. A married couple filing a joint tax return and earning $17,000 or less in 2011 is in the 10% tax bracket, and their short-term capital gains are taxed at 10%.

LONG-TERM GAINS: When assets are held for more than one year, long-term capital gains fall into only two possible tax brackets: 15% for those in income tax brackets of 25% or above and 0% for those in the 15% and 10% brackets. The 0% rate was implemented in 2008 and was to expire after 2010. It has now been extended to apply in 2011 and 2012.

Capital Gains 2011 - 2013					
	2011 - 2012		2013		
Ordinary Income Tax Rate	Short-term Capital Gains Tax Rate	Long-term Capital Gains Tax Rate	Ordinary Income Tax Rate	Short-term Capital Gains Tax Rate	Long-term Capital Gains Tax Rate
10%	10%	0%	15%	15%	10%
15%	15%	0%	28%	28%	20%
25%	25%	15%	31%	31%	31%
33%	33%	15%	36%	36%	20%
35%	35%	15%	39.6%	39.6%	20%

Assets Held at Death

In 2010, a new carryover basis arrived in conjunction with the repeal of the estate tax: Appreciated assets owned at the time of a decedent's death during 2010 would have the same basis for capital gains purposes as the decedent.

Not all of the gains would be taxable. There would be no capital gains tax on the first $1.3 million of capital gains transferred to a non-spouse and the first $3 million of capital gains transferred to a spouse. However, estates of decedents dying in 2010 can elect to apply 2011 rules, including the top estate tax exclusion of $5 million and the unlimited stepped-up basis.

For 2011 and 2012, the tax rules applicable during 2001 through 2009, including the traditional stepped-up basis, are all back in place. So appreciated assets owned at death by a decedent dying during 2011 or 2012 will have a basis that is stepped up to the value at the date of the decedent's death.

Note: If the property is not disposed of within six months of the decedent's death, the executor may elect to use the fair market value of the property six months after the date of death.

After 2012, the "Bush tax cuts" may expire again, and

certain tax rates may automatically revert to earlier levels if Congress fails to take action. The stepped-up basis was in effect previously, so it would apparently continue. It is also likely that the stepped-up basis would continue in conjunction with the ongoing Federal estate tax because the carryover basis was linked to the total repeal of the estate tax. However, because Congress needs to take action on income and estate taxes before 2013, there is no absolute guarantee that the stepped-up basis will continue.

Note: For assets that have depreciated at the date of death, the beneficiaries get the fair market value at date of death and not the cost basis.

Capital Gains Maneuvers

There are a number of newer and older techniques and rules for keeping capital gains taxation under control. Bear in mind that state income taxes, as well as brokerage fees, may apply to certain transactions separately from capital gains consequences.

Maximize Zero Brackets: Taxpayers in the 15% and 10% income tax brackets pay 0% capital gains during 2011 and 2012. This is a tax advantage that applied in recent years and was supposed to expire after 2010. The extension of this 0% rate for two years is a rare opportunity for those who qualify.

Example One: Executive John was downsized in 2010. He is unemployed during most of 2011. He and his wife have joint income of $45,000 for 2011 when the 15% bracket applies to joint filers making up to $69,000. John can sell stocks for gains of $24,000 without incurring any capital gains.

Example Two: Some commentators suggest gifting appreciated assets to those in lower tax brackets, such as parents or children, and then having those persons sell the appreciated securities or other property while the 0% rate applies. **Caveat:** This technique is not new—it was applied in previous years when lower tax brackets had other capital gains advantages. However, this is not a technique for unadvised amateurs. Control over the sale and use of funds after gifting could be scrutinized in an audit as a step transaction.

Example Three: A retiree with appreciated assets can take advantage of the low rates to sell appreciated securities without any gains and acquire different investment positions or buy back the original positions after 30 days, i.e., in compliance with the wash sale rule. Thus, the zero capital gains rate provides a qualified investor with a free pass to reset his or her portfolio.

Offsetting Losses: Taxable gains can be offset by losses that are taken in the same year. If there are excess losses, they can be carried over, but only $3,000 of the carried-over losses can be used each year thereafter.

Primary Residence: A married couple filing jointly can exclude up to $500,000 of capital gains when selling a home that has served as a primary residence during two of the previous five years. This is a renewable tax break, in that it can be used on a succession of homes that are used as primary residences. For an individual taxpayer, the exclusion is $250,000. Special rules apply for partial residencies and military service.

1031 Exchanges: If a property owner is selling appreciated property and plans on investing in other real estate, it may be possible to defer tax on capital gains by using a like-kind exchange under Section 1031 of the Internal Revenue Code. The requirements for this include utilizing all of the net proceeds from the sale of real estate in purchasing replacement property. Identification of the replacement property to be purchased must be made within 45 days of the sale of the original property. The 45-day rule is absolute—there are no extensions. However, it is possible to name multiple target properties that are under consideration. The replacement property must be acquired within six months under the 180-day exchange rule. 1031 exchanges are accomplished through a Qualified Intermediary.

Charitable Gifts: A transfer of equity to a charity can avoid tax on the appreciation in value. Someone who is inclined to donate to a charity can avoid capital gains tax by making the gift with appreciated property. Some caveats apply. Where there is a gift of property owned for less than a year, only the donor's cost basis is deductible. Example: Jane buys stock for $10,000, and it rises in value to $20,000 in six months. Jane gives the stock to a charity. Jane only gets to deduct $10,000, her cost basis. If Jane holds the property for one year and donates the property, she can deduct $20,000. Gifts of tangible personal property may also backfire. The ubiquitous example is the gift of a valuable painting to a hospital. The donor will only be able to deduct the value of the painting for its use in decorating the wall and not the investment value of the painting.

Life Insurance: If you cash in a life insurance policy or sell a policy to a third party, the proceeds are subject to taxation on any capital gains. If the proceeds are paid to a beneficiary upon death of the insured, there is no capital gains tax.

Permanent Assets: If assets are going to remain in the family for many generations, it makes sense to have them avoid capital gains tax, as well as transfer taxation at successive generations, by establishing long-term dynasty trusts.

Estate Planning Contexts

Holding all appreciated assets until death for the stepped-up basis would certainly avoid all capital gains and could trump other techniques to some extent. So if estate planning were only about Federal estate tax and capital gains, the vast majority of American taxpayers would rely on the $5 million exclusion from Federal estate tax that now applies (and the portability rule that now allows unexhausted exclusions to be utilized by a surviving spouse), as well as the stepped-up basis, to avoid capital gains on appreciated assets owned at death.

There are, however, numerous other considerations that require hands-on treatment of capital gains and estate planning.

Older buildings that are owned as C corporations and that have been fully depreciated can be tax time bombs that, upon ultimate disposition, could be hit with local, state, and Federal income taxes. Conversion of entities to obtain more favorable disposition and/or lifetime swapping of buildings using 1031 exchanges may be more favorable.

State estate and inheritance taxes can be huge tax liabilities. The creation of a succession plan for businesses and properties that is integrated with an estate plan enables the engines of wealth to reach the next generation.

Older or disabled taxpayers who may need long-term assisted care or nursing homes can exhaust all of their remaining assets and then rely on Medicaid. For many such people, a planned lifetime distribution of property, in compliance with the five-year look-back rule, allows the transfer of life savings to the next generation, as well as the proper qualification for Medicaid.

Asset protection for assets passing to the next generation must address the potential that beneficiaries will go bankrupt, have major creditors, get divorced, or tear through funds rapidly without putting aside funds for the education of one's grandchildren or other needs.

Advance planning and lifetime funding of trusts can ensure multiple generations of prudent spending and assets that remain protected from such creditors and other problems.

Even assuming the exclusion and stepped-up basis continue for the next generation, the resulting do-nothing strategy that testators might take would be ill advised in most cases.

"Adversity is the foundation of virtue."

--Japanese Proverb

Shaky Forecasts

Can future capital gains be taken for granted? Where is the global economy heading? Recent events in Japan illustrate how little we can truly anticipate.

Japan recently experienced a massive earthquake, followed by a destructive tsunami. Damages may exceed $300 billion (in U.S. dollars), and the cost in human tragedy is immeasurable.

In the aftermath, a series of catastrophic problems at the Fukushima Daiichi's nuclear power plant have resulted in radiation problems with horrendous human and economic consequences of untold proportions. With nuclear reactors offline, Japan may experience additional repercussions from blackouts in the Tokyo area during mid-2011, with significant consequences for its economic output.

Economic projections based on these events have varied to opposite extremes. Some experts have said the economic impact will be minor and temporary. Other experts have warned of the potential for a global recession and project a five-year time frame for Japan's recovery.

Some experts indicate negative impacts on the economy of the United States or certain industries. Other experts point to specific areas of the American economy that may actually benefit going forward. Some observers feel that the nuclear energy industry may never recover.

Mother Nature regularly reminds mankind of the fragility of life. When Japan—the world's third largest economy—has a setback of such magnitude, there are several financial planning lessons to be learned as well.

- No one could foretell the timing or scope of the disaster.

- The experts do not agree about the financial consequences, and a significant number of the "experts"

will ultimately be proved to be totally wrong.

• There is no guarantee for the growth of a particular nation's economy over a short time frame.

• It is difficult to project capital gains for any particular asset over a short period of time.

Economic Trends

In September, 2009, Price Waterhouse Coopers predicted that commercial real estate would linger in recession through 2011 and begin to recover in 2012. More recently, Price Waterhouse Coopers issued a first-quarter survey during 2011 that had investor optimism rising and commercial real estate euphemistically described as "moving past the bottom of the current cycle."

That positive spin at least places commercial real estate vaguely above the very bottom. Meanwhile, the National Association of Realtors predicted that sales of existing homes, which fell by 4.8% in 2010, will rise 7.9% in 2011, with prices remaining relatively flat.

But while predictions were being calculated, the earthquake and tsunami struck on March 11, 2011, the nuclear reactor story unfolded over a period of several weeks thereafter, and military conflicts began in Libya. Oil prices immediately spiked upward.

Delayed reactions may play out over April and May in various ways. American assembly lines for automobiles and computers may face shortages of high-tech components from Japan. Toyota, Mazda, and Honda promptly reduced production at American plants.

Where Are the Gains?

Retirees search for safe havens where nest eggs can at least retain value. Investors riding the waves of volatile markets are more concerned with fast returns and faster escapes than long-term capital gains.

Stock Market: Historically, over time, assets rise in value. Stock markets have rewarded "buy-and-hold" investors. Yet even this basic premise faces an uncertain future. Is the market in a growth trend that will have the Dow Jones Industrial Average breaking the 20,000 level at the end of the decade? Or will we plateau between 9,000 and 12,000? Look at how the Dow performed between 1965 and 1980. If a critical world event impacts the financial markets, some investors will suffer while others will seize the opportunity.

Gold: After a 1980 spike up to about $800, gold spent about 16 years in a holding pattern, hovering roughly between $300 and $450. There were several long economic expansions during those years. But the economic troubles of the past two years have pushed gold to historic heights of $1,400. Investors may still find some attraction in gold as a hedge, and uncertainty may push it still higher, but the recent buildup limits its potential for large capital gains in the short term.

Real Estate: A recovery in the economy may mean more activity in real estate, but that may not translate into significant capital gains for a considerable time. When recovery arrives in any form, inflation is likely to follow, along with higher interest rates. There is a backlog of foreclosures that have not been processed, and many homeowners are engaging in strategic defaults—intentionally walking away from large mortgages that exceed the value of the homes and then starting over with other properties. These factors can keep home values from recovering or increasing for the next several years. The longer term projection, following higher inflation years that some analysts feel are inevitable, is quite positive. Those investors who have cash now—and who can accumulate desirable locations from foreclosure sales and then sit back for a decade—may be positioned for large gains.

Business Assets: Owners holding stock in closely held companies, executives with significant stock options, small business owners who build businesses over many years—these are the most likely candidates who will experience significant long-term capital gains.

Conclusions

These are dynamic times of high risk, and no one set of investments can deliver capital gains on a set schedule. There are opportunities in every market…but no guarantees of success. The discussion above is not investment advice and is only offered to provide a broad context for planning considerations.

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