Capital Gains Planning After 2008

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The election cycle is now in full swing with new tax policies being debated in 2008. Both political parties have their own view on what are the right tax rates to impose on all of us. Unfortunately, capital gains rate are the most often changed.
In May 2006, President Bush signed a tax act dealing with lower capital gain rates. It basically extended, with few exceptions, the favorable capital gains and dividends rates from the prior tax act that were due to expire at the end of 2008. The 2006 Act extends the expiration of the lower tax rates applicable to long term capital gains and qualifying dividend income from 2008 until 2010. The 2003 Act lowered these tax rates for most taxpayers from 20% to 15% until December 31, 2008. The 2003 Act also created a 5% tax rate until 2007 for taxpayers who would otherwise be taxed at 10% or 15% on ordinary income. The 5% tax rate changes to zero for 2008.
If the Democrats win, a 28% capital gain rate is more than likely to be the new rate compared to the current 15% capital gain rate mentioned above. If this is the case what will and are now some of the basic planning that can be done at the business and individual levels?

Planning with Corporations.

Current Distributions. If your corporation is currently taxed as a C corporation, either cash dividends or distribution of appreciated assets will result in double taxation unless the corporation has a NOL at its level. If there is no NOL, think about a S corporation election and being subject to the 10 years rule for built in capital gains (tax on the corporate level) on the corporation's current assets.

Today, a C corporation will still incur a corporate-level income tax, so there is still some double taxation of the dividend, although it is much reduced with the 15% dividend tax rate. For existing C corporations, salaries may be reduced to the extent not needed to offset income (i.e., large depreciation deductions), thereby permitting the payment of dividends to owners, reducing the overall tax impact of the payments. The new lower tax rates on dividends provide multiple planning opportunities for C corporations.

Partial or Complete liquidations. You can do either a partial or complete liquidation of the corporation. You must watch out for the IRS claiming that there was a divisive merger if assets are contributed back to corporation. There is less

chance to this attack if the assets were contributed to a LLC. If there is excessive cash in the C Corporation do a dividend distribution.

Planning with Individuals.

Installment Sale Planning. A popular or at least much discussed tax deferral technique was utilizing a private annuity trust. This type of planning is now limited. Today all gain is recognized at time of sale. I will briefly discuss the traditional installment sale note of deferring gain over the life of the note and also a self cancelling installment note (SCIN).
The most important planning decision you may make is ***electing out*** of the installment sale if there is in fact a 13% increase in capital gains for any sale you do this year. It is important not to play games.

What happens, if rates are changed and you did an installment sale? Is there any possible planning that can be done to avoid the higher rates? The answer is yes, but you have to be very careful under the IRS regulations. You may be able to change the terms of the note without it being deemed to have been modified. If the IRS finds a modification of the note there is a sale or exchange of the note and the gains are accelerated.

A simple technique would be to pledge the note (this is a modification but falls within an exception). The new rate of interest may be higher than the old but the savings on tax rates may be worth while. This will provide you with cash to pay the tax. The pledging technique is better than the gifting of the note that would terminate the election but does not provide you with the cash to pay the tax.

Self Cancelling Installment Note. Traditionally, a SCIN represents a planning opportunity for senior family members who desire to retain the cash flow from certain assets but want to transfer those assets to junior family members with reduced gift or estate tax consequences. The SCIN would call for a specified number of payments at a fixed rate. The SCIN could provide for interest only and a balloon of principal on maturity. This planning avoid the capital gain treatment and removal of the note from senior family member's estate on death.

Proper valuation by a qualified appraiser is the key to making the SCIN a viable option. You cannot do this type of planning with the grantor on his or her death bed. You must be able to prove that there was a 50% or more chance of death not occurring within next 12 months at the time of entering into a SCIN transaction.