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Tax-free capital gains

The maximum tax on long-term capital gains is 23.8% at top income levels. The lowest possible tax on long-term gains is 0%. This bargain rate is available for those in the two lowest income tax brackets, 10% and 15%. That means marrieds filing jointly with taxable income up to $74,900 and singles up to $37,450. The same 0% rate applies to qualified dividends. Here are three examples of how to take advantage of this tax benefit.

Pre-retirees. Sam and Janet have a combined taxable income of $100,000, so they will be taxed if they sell the $20,000 worth of stock this year, stock that they bought for $5,000 years ago. Their gain is $15,000. As they are in the 25% tax bracket, the gain would be taxed at 15%, $2,250. Next year Janet will retire, and the couple's combined income will fall to $60,000. If they can wait until then to sell, the entire gain will be tax free. Note that if the gain lifts the couple's income beyond the 15% tax bracket, the excess will be taxed.

Free-lancers. Jack's income is subject to some variability from year to year. This year he expects his taxable income to be only $30,000. Jack has $8,000 worth of mutual funds that he bought for $4,000. He doesn't need to tap the money, but Jack has an opportunity to capture a tax-free basis step-up. Jack can sell his shares one day and repurchase them the next. His $4,000 gain will be taxable, but the 0% rate applies. Jack's new tax basis will be $8,000 when he decides to liquidate this investment in the future. Note that the rule against wash sales, which applies to a sale and repurchase of the same investment to secure a tax loss, does not apply to wash sales that lock in capital gains.

Students. Kathy just finished grad school, and she has a low income and lots of debt. Grandpa and Grandma are very well off and would like to help. The grandparents have $28,000 worth of stock with a tax basis of $8,000 that they are considering tapping for this purpose. Should they sell the stock, the $20,000 gain will be taxed at 23.8%, leaving net proceeds of $20,240 for Kathy. The better course is to give the shares to Kathy and have her sell them. The entire $4,760 capital gains tax will be avoided, so long as the sale does not lift Kathy's taxable income above $37,450. Note that no gift tax will be due either, and Grandpa and Grandma each have a $14,000 gift tax annual exclusion.

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