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THE YEAR OF TAX-FREE CAPITAL GAIN HAS ARRIVED

Capital Gain Rate Drop Creates Potential to Save Taxpayers Thousands of Tax Dollars.

New York, NY April 23, 2008 —“The ultimate tax rate reduction for capital gains took effect on January 1, 2008, so don’t miss it,” says Bob D. Scharin, Senior Tax Analyst from the Tax & Accounting business of Thomson Reuters. Legislation enacted back in 2003 provides that certain capital gain (and qualified dividend income that is taxed like long-term capital gain) is subject to a 0% tax rate—converting this money into tax-free income. Now that your 2007 tax return is filed, it is time to begin thinking of how you will implement strategies for this 2008 tax break.

In plain English, the 0% rate means that you owe no tax on capital gain to the extent your taxable income does not exceed the level at which the 25% regular income tax bracket kicks in. For 2008, this threshold is taxable income of up to:

- \$65,100 for married taxpayers who file joint returns.
- \$43,650 for heads of households.
- \$32,550 for other unmarried taxpayers and married taxpayers who file separate returns.

This seemingly simple tax break has a few confusing wrinkles. Scharin asks and answers questions that clarify common misconceptions.

How much tax can this save me? By reducing the capital gain rate from 5% to 0% on the above amounts of taxable income, the maximum tax savings are as follows:

- \$3,255 for married taxpayers who file joint returns.
- \$2,182.50 for heads of households.
- \$1,627.50 for other unmarried taxpayers and married taxpayers who file separate returns.

These figures are 5% of the income limits presented above.

Must my income be below these thresholds to qualify? No. First off, the tax break applies to *taxable* income. Depending on your deductions, your gross income can be considerably more. Also, you may qualify for some tax-free income even if your total taxable income exceeds threshold amounts. Your non-capital gain and dividend income reduces your window of opportunity to take advantage of this 0% rate. Thus, you can derive some benefit from the 0% rate if your *nonqualifying* income is less than the above threshold amounts.

For instance, suppose a married couple has \$70,000 of taxable income. It consists of \$60,000 of wages and interest income, plus \$10,000 of capital gains. The couple’s taxable income exceeds the \$65,100 threshold, but they pay no tax on \$5,100 of the



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capital gains. That is the amount by which the applicable taxable threshold exceeds their \$60,000 of income from sources not subject to the favorable capital gain rate. The remaining \$4,900 of capital gain would be taxed at a 15% rate.

Planning tip: If you are in this situation, seek out ways to reduce your income that is not eligible for the 0% rate—by increasing contributions to a Section 401(k) plan at work or by investing in certificates of deposit or Treasury bills that defer into 2009 interest earned in 2008. Retirees can minimize their retirement plan distributions and instead get cash for living expenses by selling appreciated investments.

Do all capital gains and dividends qualify? No. Only the types of capital gain and dividends that would otherwise be subject to the 15% top rate applicable to those with higher incomes are eligible. Gains must be long-term capital gains, which means gain from investments held for longer than one year. Also, gains from the sale of collectibles cannot be sheltered from tax by this break.

Can I shift capital gains to lower-income family members? Yes. You may make gifts of appreciated assets that the gift recipients then sell. The capital gains will be reported on their tax returns. The long-term capital gain holding period will be measured by the date the gift-giver acquired the property. If you held it for over a year, the gift recipient may sell right away and still qualify for long-term capital gain treatment. That treatment can mean zero tax.

This strategy does come with two caveats, Scharin warns.

1. **The tax-free gains can indirectly raise someone's tax bill.** Before you place an order to sell a profitable investment, consider the effect that the extra capital gain income will have—even if the income itself is tax-free. Although the gain may not be taxed, it will raise your adjusted gross income. This could, in turn, increase the portion of Social Security benefits subject to tax.
2. **No kidding about the kiddie tax.** If your children are subject to the kiddie tax and your income is too high for the 0% capital gain rate, they will not qualify for it either. Under the kiddie tax, in 2008, unearned (i.e., nonwage) income in excess of \$1,800 of those up to age 18—or 23 if full-time students—is taxed at the top tax rate of their parents. If the parents' income falls into a 25% or higher tax rate bracket, the children cannot qualify for the 0% rate.

In 2007, the kiddie tax applied only up to age 17. That the age limit increased in the same year as the capital gain rate dropped is no coincidence. Congress saw the prospect of families shifting income to college students to take advantage of the 0% rate as a loophole too big to avoid being plugged up.

Planning tip. For purposes of the kiddie tax, an individual comes under the full-time student status only if he or she is a full-time student in at least five calendar months of the year. Thus, a child who takes a year off between attending high school and college would be a full time student for the year he or she graduated in May or June, but would not be a full-time student the following year if college did not start until September.

Can I still deduct capital losses? Yes, but capital losses must first be used to offset capital gains. Excess losses may be used to offset up to \$3,000 of other income (e.g.,



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wages). “People who are eligible for the 0% rate on capital gain derive no tax benefit from offsetting those gains with capital losses. If possible, they should defer the losses into a future year when they either have no capital gains or the gains are subject to tax,” Scharin explains.

Can the 0% rate hurt my eligibility for stimulus payments? In some circumstances, the answer is “yes,” and some background information is needed to understand how.

Most stimulus payments are being sent out in 2008 based on 2007 income. If you did not qualify for the maximum payment amount (i.e., \$600 per taxpayer, \$1,200 for joint returns, and \$300 for qualifying children) that year, you get a second chance for more money based on your 2008 return.

If you do not receive at least \$3,000 of wages, Social Security benefits, or other qualifying income, you can still get a minimum payment of \$300 (\$600 for joint return filers) if your gross income is at least as much as the applicable basic standard deduction plus the exemption amount (twice the exemption amount for a joint return) and you owe some tax. Consequently, \$1 of tax liability can put some individuals in line for a \$300 (\$600 for joint return filers) stimulus payment.

Here’s where the problem arises: A capital gain can boost a low-income taxpayer’s gross income above this threshold, but the 0% rate would stop the individual from owing any tax. No tax liability would mean no stimulus payment.

Will the 0% rate be around longer than just this year? Yes. As the law reads now, the 0% rate will be around through 2010. If your family cannot take advantage of it this year, you may be able to derive tax savings in the future.

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