

WESCAP MANAGEMENT GROUP

1314 W. Glenoaks Blvd., Suite 204
Glendale, CA. 91201
(818) 552-2130

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Items of Interest to WESCAP Clients and Other Interested Readers

A Taxing Market

How do you avoid paying capital gain taxes forever? It's simple, but there is a downside. You have to die first. At death, appreciated capital gain qualifying assets get a step-up in cost basis—a 100% step-up in community property states like California or 50% if held jointly or in most other states. This means these assets can be sold by your spouse or heirs with little or no income tax.

However, you might have an interest in using these assets before death. Also, what if the asset appears to be overvalued or you just have too many eggs in one basket?

The answer is tax-sensitive asset management. For marketable securities and real estate, a number of techniques are available. Certain estate planning techniques can also be used to reduce current income taxes.

Real Estate—A number of methods exist to reduce capital gains taxes, including:

- \$250,000 primary residence exclusion (\$500,000 if married)
- Sale via installment note
- 1031 tax-free exchange for investment real estate
- Borrow out equity via home loan or line of credit and invest elsewhere

Marketable Securities—Stocks, bonds and mutual funds offer numerous tax management techniques. These include:

- Sell assets with capital losses and buy them back after 30 days or immediately buy a similar (but not identical) security.
- Sell high cost basis securities. If you own two similar securities and one has a big gain, sell the other one. Also both last-in-first-out (LIFO), and specific “lot” purchase date identification can be used to sell only the high cost basis securities (e.g., multiple buys or reinvested dividends). If specific purchase date identification is used, this must be identified to the broker when placing the sell order. Care must be taken not to sell capital gain assets held less than one year.
- Purchase mutual funds with imbedded capital losses. This makes sense only if you believe the specific mutual fund will recover soon, since **investment returns are always more important than tax considerations**.
- Find tax efficient mutual funds using either low turnover (e.g. most index funds) or via active tax management by the fund managers. Note however that mutual fund net withdrawals *by*

others can trigger capital gains *to you* regardless of the fund's strategy.

- Continue to hold assets with capital gains. Adjust other parts of the portfolio to accommodate *core* holdings. These "completion" portfolios, which also occur when one holds limited choice 401(k) or annuity assets, often require additional research and unique portfolio weightings in order to structure the entire portfolio rationally. Even so, the resulting structure is rarely as optimal as it could be if these low cost basis assets did not exist.
- Try to convert ordinary income and short-term gains into long-term capital gains. Waiting a year for long-term capital gains treatment is an obvious choice. If the asset is overvalued though, then using stop-loss orders may be advisable. A short term gain is still preferable to any kind of loss.

Trusts/Gifts/Other Considerations

Lastly, asset sales can be combined with estate tax planning techniques. Sometimes charitable remainder or lead trusts are appropriate. Assets can be sold within the trust without capital gain tax and either the income or residual value is donated to charity. The remainder trust is useful if you need income and must sell the asset to get this income and if other tax reduction techniques won't work and you are not concerned about leaving the asset to heirs. To offset the reduction in your estate, you could buy life insurance, but this can be quite expensive.

Giving appreciated assets to those in a low tax bracket, along with selling capital loss assets yourself can result in an after-tax return greater than the pre-tax return (when both parties are considered).

However, reducing tax now is not always the best choice. Incurring a smaller tax now can often result in much greater tax savings later. Roth IRA conversions and gifts that exceed \$10,000 per donee often result in much lower total long-term taxes.

With tax management, there are tradeoffs. The asset kept may do less well than alternatives. However, the tax savings may more than offset the performance degradation. Trading costs may also be higher. What really counts is not whether costs could have been lower or returns somewhat higher, but what you end up with. "Will I increase my long-term net worth?" is the question that should be asked when evaluating any strategy.

"Do I have too much invested in this one asset?" is another question that should be asked. Don't jeopardize your financial security with a dangerous over-allocation. Sometimes a sale or gift is required to reduce risk.

Tax management, in all of its permutations, can significantly boost family spendable resources. There are benefits and drawbacks to many of these techniques, so determining the best mix of choices can be made only on a case-by-case basis.

If you have questions about the above, please contact Mark Gleason, Rick Weinlein or Joel Edstrom at (818) 552-2130, fax: (818) 552-2133, E-mail: Wescap@pacbell.net. WESCAP Management Group provides high quality, personalized, objective financial and investment advice to individuals.