# GETTING STARTED IN TAX-SAVVY INVESTING

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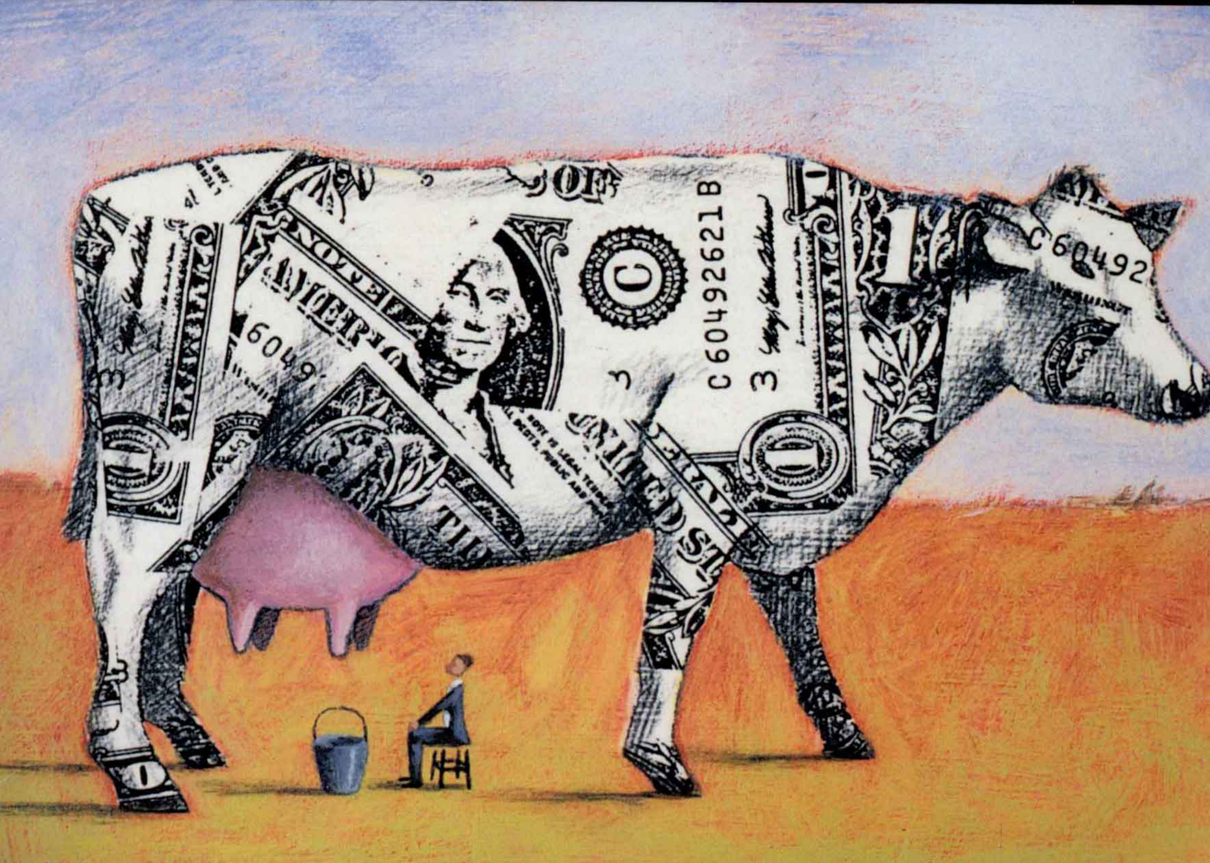


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ANDREW WESTHEM
DON KORN

# Getting Started in Tax-Savvy Investing

Andrew Westhem
Don Korn

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# Introduction

Despite all the articles about "tax cuts" and "tax relief," the truth is that Americans are paying taxes at much higher levels than historically has been the case. Our political system virtually dictates this result.

After all, tax laws are passed by Congress and signed by Presidents: politicians all. Their main goal is reelection; in order to attain this goal they need enormous amounts of money. That's why politicians are always out raising funds.

Where do most of those funds come from? From special interest groups, big corporations, and wealthy families. Those generous donors all want something in return: tax breaks.

## BANKING ON BREAKS

As a result, the U.S. tax code is filled with tax deductions, tax exemptions, and tax credits. Many of these tax breaks have been around for so long they're now taken for granted.

For example, if you own a home you can deduct the interest on your mortgage. Everybody knows that; it's as natural as the sun rising in the east.

In truth, though, the United States is the only major nation with deductible mortgage interest (such interest may be partially deductible in the United Kingdom) and this deduction has a relatively brief history. Back in the Depression of the 1930s, President Franklin Roosevelt pushed through this deduction to help the real estate interests that had supported his campaign.

## HOW THE RICH GET RICHER

As you might expect, many tax code loopholes are intended to benefit wealthy families, who want to minimize gift and estate taxes as well as income taxes. Ever since the tax code was overhauled in 1913, wealthy families have had their lawyers and accountants working on ways to hold down their tax bills.

Until now, many of those techniques were closely held secrets. In this book, though, we're breaking the code of silence and revealing all the insider's tax-avoidance tricks and tactics for you to use in your investing.

## ARE YOU READY FOR 35,000 ON THE DOW?

Chances are, you'll need to use all the tax breaks available. Many observers expect the coming years will be great ones for investors. Harry S. Dent, a consultant and economic forecaster based in Moss Beach, California, forecasts the Dow Jones Industrial Average will hit 35,000 by 2008.

### *The Stock Market's Baby Boom*

Dent's optimism stems from demographics. For the average individual, saving accelerates from age 35 to age 68 while spending peaks around age 46.5. Thus, both patterns are moving up between ages 35 and 46.5. Money moves into stocks at that stage of life, when families have both high discretionary income and a relatively long time before retirement.

As the century turns, the fabled baby boom generation is moving into that age cohort. The first boomers appeared in 1946, right after World War II, so they'll turn 55 in the year 2001, with their younger siblings right behind them. In 1987, there were about 20 million Americans in the 45 to 54 age bracket; that number is projected to crest at more than 40 million in 2008.

Impact: The baby boomers are moving into their peak spending and investing years, so the stock market is likely to bound from peak to peak.

### *History Lesson*

If you participate in the stock market, such bullish views are welcome news. Dent is forecasting that the market will rise by about 16% per year.

Even if you take a less aggressive stance and assume, say, a 12% annual return (the average over the past 65 years) your money will double every six years.

## THE MILLIONAIRE AT HOME

Think about that for awhile. Suppose you're 55, with a modest $200,000 invested in stocks.

- ✔ If you earn 12% for the next six years, your $200,000 will become $400,000.
- ✔ Assume another 12% return over the subsequent six years. Your money will double again, to $800,000. And that's just the money you have saved now.
- ✔ Assuming that you'll continue to save and invest over the intervening 12 years, you'll likely have over $1 million by then, perhaps well over $1 million.

By age 67, when you're ready to retire, you'll be a millionaire.

### *Tax Trap*

Well, not really. Those numbers are all pretax. To make the most of the coming boom you need to minimize the tax bite on your income and on your wealth. If you understand these rules and implement some basic planning strategies—the strategies revealed in this book—you can turn these years of prosperity into a long-term wealth-building machine that literally can pay out millions to you and your loved ones.

## HOW TO READ THIS BOOK

We've organized this book along fairly simple lines.

First, we explain the tax implications of the investments you're likely to hold: stocks, bonds, mutual funds, real estate.

Next, we cover tax-favored ways of saving for retirement through

IRAs, 401(k)s, and so on. (We also explain the tax angles involved in making the most of your Social Security benefits.)

From there we go on to cover life insurance and related vehicles. Life insurance enjoys some of the richest tax benefits in the tax code, a situation likely to persist.

We provide special coverage for business owners who decide their best investment is their own company.

Before winding up with some tax-wise final thoughts, we shift our focus from income tax savings to estate tax savings. After all, why devote your energies to cutting income tax, at rates no higher than 39.6% (under current federal law), if your family winds up paying estate tax at rates up to 55%?

Our goal is to help you slash all of your tax bills, leaving more of your wealth for yourself, your loved ones, and your favored causes.

# Contents

Chapter 1

# Getting Started with Stocks

Every year, investors pour billions of dollars into mutual funds, especially stock funds. And, every year, investors are shocked by the tax bills those funds generate.

When taxes are considered, the old-fashioned way is better: Buy individual stocks instead. As long as you buy and hold with minimal trading, your tax bill from your investments will be negligible.

## THE MUTUAL FUND MINEFIELD

To understand the advantages of buying stocks directly, consider the tax rules governing mutual funds. Federal tax law requires that mutual funds distribute at least 98% of their *ordinary income* and net realized gains for a calendar year within that same calendar year.

**ordinary income** taxable income that receives no favorable tax treatment.

Suppose, for example, ABC Growth Fund invested $1 million in Microsoft back in the 1980s. Since then it has held on to Microsoft, watching the stock appreciate—and generating no tax obligation.

In the year 2000, concerned about the company's battles with the government, ABC Growth Fund sells its Microsoft stake, which has grown to $20 million.

The company has a long-term gain of $19 million, practically all of which must be distributed to shareholders.

## FUNDS CHURN, INVESTORS ARE BURNED

Of course, ABC Growth Fund won't have only one sale of its Microsoft stock during the year. More likely, it will have dozens of sales, each of which generates a gain or a loss. (The average stock fund has a *turnover rate* greater than 80%, so a typical mutual fund is a fairly active trader.)

**turnover rate**
a measure of how actively a mutual fund trades its holdings. A fund with a 100% turnover rate holds each investment for an average of one year before selling it.

The net trading gains must be distributed annually. If ABC Growth Fund winds up the year with $50 million in net gains and there are 50 million shares outstanding, it will distribute $1 per share.

## MANY UNHAPPY RETURNS

Such distributions are taxable to you, whether you reinvest your capital gains distributions and thus collect no cash. That's true even if the fund loses value in a year.

This happens frequently. Indeed, in times of market trouble investors bail out of losing funds, and those investors who stay behind (or buy in shortly before the distribution date) get larger per-share distributions, so they owe more tax.

If you invest after the fund enjoyed big gains but before the distribution, you'll still owe tax on the distribution you receive.

In this example, ABC Growth Fund sells Microsoft and other long-term holdings as well, winding up distributing $1 per share. Suppose you bought ABC Growth Fund at $20 per share just before the $1 per share distribution (which drops the price to $19 per share). You would get $1 per share in distributions, on which you'll owe tax. In effect, you're paying a tax on a return of your own capital.

## SHORT GAINS, LARGE PAIN

The Taxpayer Relief Act of 1997 provided a cut in the capital gains tax, and subsequent legislation in 1998 enhanced this tax break. Now, if you hold a stock, mutual fund share, or other investment for more than one year, any gain will be taxed no more than 20% (down from 28%), even if you are in a higher tax bracket.

On the other hand, when you buy mutual funds, net realized gains must be distributed to investors each year. Some distributions will be short-term capital gains, taxable at rates up to 39.6%; only if the fund has held the shares for more than 12 months will shareholders get the benefit of the 20% rate.

It makes no difference whether you reinvest the short-term capital gains distribution; it makes no difference how long you've held the shares of that mutual fund. If you own the fund in a taxable account, you'll owe short-term capital gains tax at rates up to 39.6%. (Any *dividends* passed through to investors also will be taxed at ordinary rates up to 39.6%.)

**dividends** payments of profit by a corporation to its shareholders.

## COSTLY COMBINATION

Most mutual funds are managed to maximize pretax rather than after-tax results, so mutual fund distributions tend to be a mix of short- and long-term gains. Although the end result will vary according to your tax bracket, your state tax situation, and your fund's trading practices, you can expect to pay around 25% of each annual distribution in tax.

Suppose, for example, Jane Jones has $10,000 invested in XYZ Value Fund. In 1999, XYZ posted a total return of 25%. Of her $2,500 return, though, about $1,000 (40%, the industry norm) came to her in the form of distributions. At an effective 25% tax rate, Jane had to pay $250, knocking her actual return from $2,500 (25%) down to $2,250 (22.5%).

Long-term, losing that much in taxes each year can make a huge difference in the wealth you accumulate.

## ROLL YOUR OWN

For more control and lower tax, you can buy individual stocks. Trading through a discount broker, costs will be minor: Online trades may be under $10 apiece.

Then, you can just hold on to your stocks indefinitely. You'll owe tax on the dividends you receive, but the average dividend yield on the S&P 500 is around 1.5%. At a 30% tax rate, your tax bill would be a token 0.45%.

## CASHING IN

Buy-and-hold is a fine investment strategy, but what if you need to get your hands on some cash? Do you have to sell shares and trigger a taxable gain?

- ✔ If your stocks appreciate and you want to cash in some of your profits, you can borrow up to 50% against the full value of your stocks. The interest you pay likely will be deductible, as an offset to taxable investment interest.
- ✔ Another possibility is to sell off your winners. You can specify which shares you want to sell, choosing those that will generate the smallest tax bill. And you can sell off some losers as an offset, reducing or eliminating your tax bill.

Impact: With some savvy planning you can wind up each year with a net realized loss of $3,000, fully deductible, while you let most of your winners ride.

## MISSION: CONTROL

You can do some of the same things with mutual funds that you can do with individual stocks. You can match winners with losers; you can borrow against your funds if they're held in a brokerage account.

However, with individual stocks you're likely to have more variability from one issue to another, which will provide you with increased flexibility for tax planning. And you'll certainly have more control—you'll realize taxable gains when you choose to do so, not at the whim of some fund manager.

## BOLD NEW WORLD

As mentioned earlier, recent changes in tax law lowered the maximum tax on capital gains from 28% to 20% on assets held more than 12 months. These changes created many new opportunities for investors.

Stocks beat bonds—by a wider margin than ever. As an investment, equity is preferable to debt, provided you diversify your holdings and stay in for the long term. Now that the tax on any gains is reduced, stocks look even better.

Impact: Don't rush to switch from stocks to bonds as you near retirement. You're better off keeping your money invested in *equities* and then meeting any cash needs by selling stocks. Changes in the tax law decrease the tax you'll pay when liquidating appreciated securities.

**equities** ownership interests. Publicly traded stocks are often called equities.

Borrowing to buy stocks or real estate makes more sense. The after-tax cost of borrowing remains the same, while your after-tax gains may be greater.

Suppose, for example, you take a $10,000 margin loan to buy stocks, paying 8% ($800) per year in interest. In a 39.6% tax bracket, deducting the interest on your income tax return will save you $317 in tax, so your net cost will be only $483 per year.

Suppose the stocks you buy go up 10% ($1,000) per year. Under prior law, your net annual gain would have been $720, after paying capital gains tax at 28%; now your after-tax gain is $800 a year.

Retirement plans are good—but not as great. Under current tax law you'll need a commitment to higher returns (perhaps by investing more in stocks) and longer holding periods for investments inside deductible individual retirement accounts (IRAs), 401(k)s, simplified employee pensions (SEPs), and other plans.

**marginal tax rate**
the rate at which your last dollar (or your next dollar) of income will be taxed. Also known as your tax bracket.

Unfortunately, all money coming out of such retirement plans would be taxed at your top *marginal tax rate* (at present as high as 39.6%), no matter how that income was derived. In essence, you lose the capital gain tax break that exists inside the plan.

Nevertheless, the longer you'll defer taxes, the better a retirement plan will work. Such plans remain particularly effective if you'll have a holding period of 20 years or more.

Tax brackets count, too. If you think you'll be in a lower bracket when you withdraw your money, perhaps after you retire, tax-deferred plans still can be very big winners.

Diversification may come easier. Your portfolio may be overweighted in shares of your employer's stock, stock options, or shares of one company given to you by family members. Selling some of those shares will reduce your exposure to one stock but may generate sizable capital gains.

**long-term capital gains**
profit from the sale of an asset held more than a year. Under current law, the maximum tax rate is 20%.

Now, rebalancing your portfolio becomes less expensive because you'll owe only 20% on *long-term capital gains*.

## *Big Break for Small Fry*

Here's a vital break for parents of young children:

The tax law also provides a bargain 10% capital gains tax rate. Taxpayers in the 15% income tax bracket pay only 10% tax on capital gains. That includes single filers with less than $25,000 in taxable income (about $45,000, filing jointly).

So here's a winning strategy: If you're cashing in appreciated securities to pay college bills, give them to your children before selling.

As long as your kids are older than 13, they likely can sell the shares and pay tax at just 10%; then they can use the net proceeds for college. You and your spouse can give away $20,000 worth of assets per year, per recipient, with no gift tax consequences.

### *Elder Shelter*

Another super strategy:

If you're helping to support elderly parents, give them appreciated securities instead of cash. Again, your parents may be able to sell and pay tax at a bargain 10% rate.

## NOW FOR THE NEGATIVES

Unfortunately, there's a downside to lower rates on long-term capital gains: The *basis step-up* has come down in value.

At your death, shares you bequeath get a step-up in *basis* to current value. For example, suppose you have a portfolio of stocks you bought for $100,000, now worth $500,000. If you die tomorrow and your son inherits, his basis in those shares moves up to $500,000. He can sell them for $500,000 and owe no capital gains tax on the $400,000 profit.

The value of this tax break is smaller now (an $80,000 savings at a 20% rate) than it was under prior law (when the savings would have been $112,000 at a 28% rate).

Formerly, many investors were frozen in place: To get the basis step-up, they held on to appreciated assets until death. Now that this tax break has been devalued, you can take some gains, pay tax at 20%, and reinvest the net proceeds where opportunities seem greater.

Ironically, charitable giving also has been devalued. The same reasoning that applies to basis step-ups also applies to using appreciated assets for charitable gifts. Under the new law, such gifts save 20 cents on the dollar, not 28 cents.

Charitable giving now depends even more on your philanthropic objectives and not as much on tax savings.

**basis step-up**
a tax break enjoyed by heirs to appreciated property. When you inherit an asset your basis is increased to its value at the owner's death, effectively eliminating the tax on all the gains that were not cashed in.

**basis**
your basis in an asset is your cost for tax purposes.

## DOWNPLAY DIVIDENDS

With all this emphasis on capital gains, what about dividends? Isn't it marvelous to invest in AT&T or Con Edison and receive a check every three months?

Not always. From a taxpayer's point of view, buying dividend-paying stocks is unattractive.

- ✔ Dividends are near historic lows, with the average stock in the Standard & Poor's 500 paying around 1.5%, as of this writing.
- ✔ The dividend income you receive will be taxed as ordinary income, with rates up to 39.6%. If you owe state or even local income tax, you could lose 40% to 45% of your dividends in taxes.
- ✔ That tax is due every year, even if you reinvest your dividends.
- ✔ On the other hand, when a stock you hold appreciates, no tax is due as long as you don't sell.
- ✔ Even when you sell a stock at a profit, federal income tax is capped at 20%, as long as you have held the stock more than 12 months.

## BEYOND THE BORDERS

Financial planners and investment advisers routinely recommend some commitment to foreign stocks as part of a diversified portfolio. Thus, some American investors have moved into foreign stocks and stock funds, such as *global funds* or *country funds*.

**global funds** investment pools that can invest anywhere in the world, including the United States.

**country funds** investment pools that invest in one particular foreign country.

You don't really need foreign stocks, but history shows that there are advantages to diversification. As of this writing, the U.S. market is strong while foreign stocks have been down, but that may not be the case in the future.

As recently as 1990, the U.S. economy seemed to be flat on its back while the Japanese seemed to dominate the world and the Japanese stock market had enjoyed a long boom. Since then, the U.S. stock market has soared while the Japanese market has fallen from 38,000 to 18,000.

## UPS AND DOWNS

The Japanese market's 1990s slump of more than 50% can be compared to the U.S. experience in 1929 to 1932,