OLD MISSION

publication of old mission investment & trust
fall and winter 2019/20

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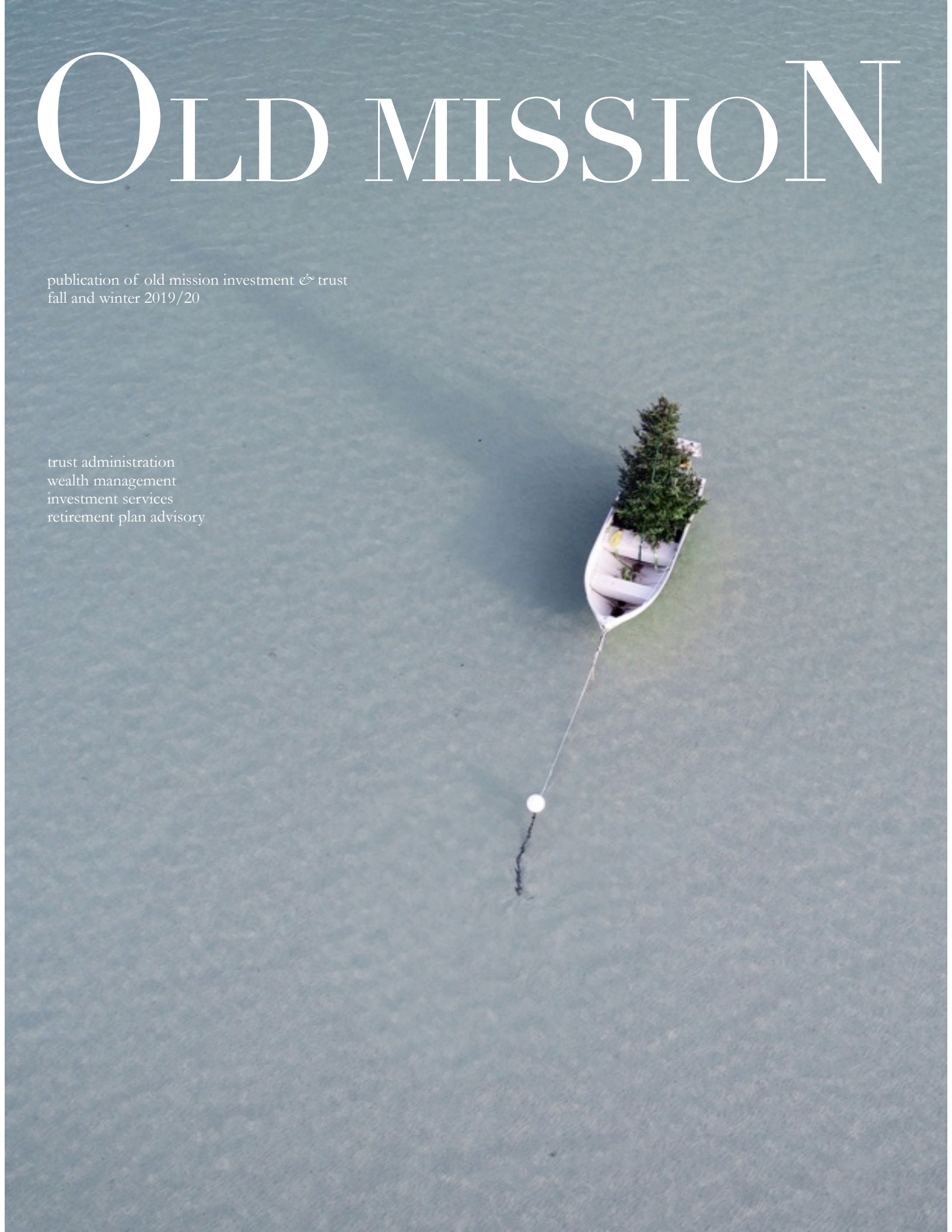
investment services
retirement plan advisory



OLD MISSION **INVESTMENT** COMPANY
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This is an abbreviated version of our firm's client publication.

For the complete copy of our publication, which includes all written commentary and articles, please contact our firm to request a copy to be mailed to you directly.

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Privately owned and independent, Old Mission Investment and Trust is a fee only wealth advisor and private trust organization. Old Mission works with families and investors through comprehensive wealth management services to achieve peace of mind for all clients.

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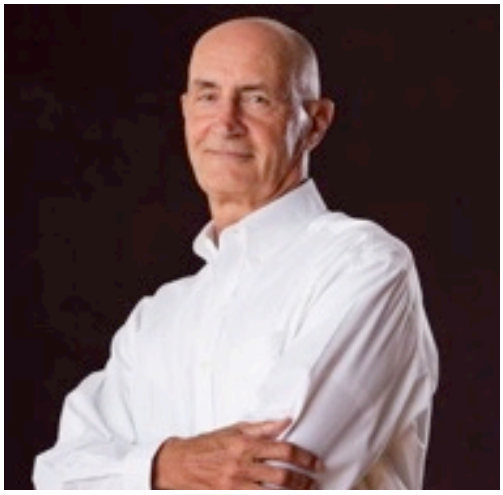

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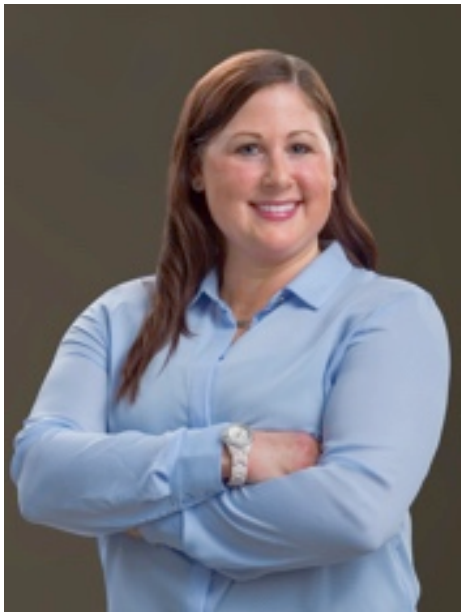

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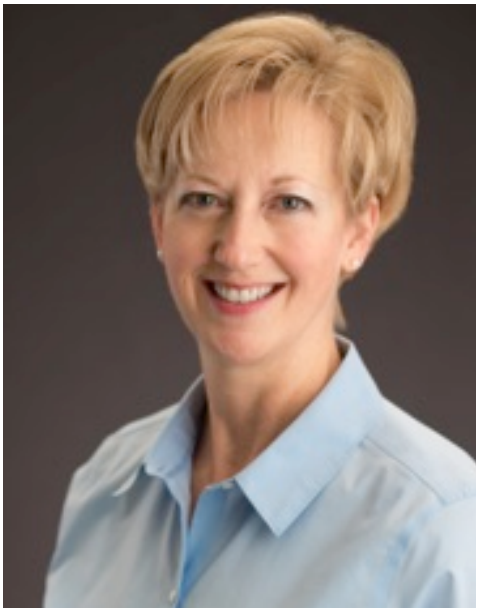

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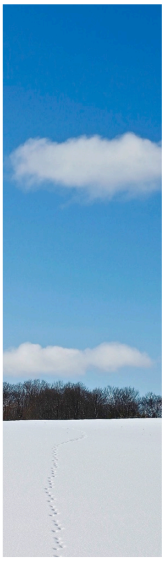
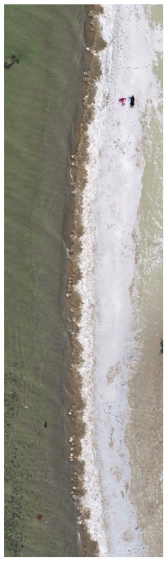
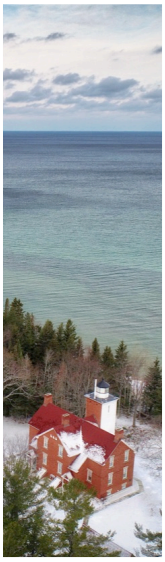



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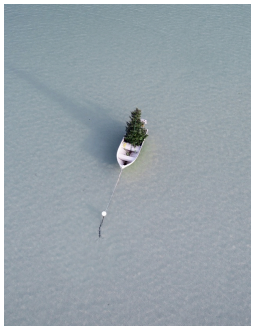

Cover Image: Christmas on Glen Lake. An annual tradition for one family as they moor a Christmas tree for the season.

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OVERVIEW

Investment & Trust

The Cricket Told Me So.

Last year at this time, we were writing about crazy financial markets taking a turn for the worse. The markets had suffered a quick 18% loss, and investors were concerned. We shared our strong belief that the markets would recover and things would work out for the best. Thankfully, they did.

Now we are seeing the flip side of that coin as the markets hit fresh new highs. The Dow Jones Industrial Average has crested 28,000 for the first time in history. Some observers seem shocked that parties haven't broken out in the lobbies of every brokerage and investment firm in the country. But I'm not surprised. The investors I know are still wary about the future, and that's a good thing. We're living through the longest bull market in history. If earnings and profitability continue to roll along, nothing necessitates that it must die anytime soon. Granted, 2019 was largely a recovery year after the huge selloff we experienced in the fourth quarter of 2018. But we'll gladly take it. Recoveries ultimately build the base on which markets continue making money in the long term.

We love talking with our clients, and appreciate it when you look to us for guidance and counsel. We feel it keenly when we sense genuine fear on the other side of the desk or at the other end of the phone. When markets move abruptly in the wrong direction, it's natural to automatically expect the worst, and believe that portfolio values will take an irreversible slide.

Human behavior around money is interesting. When greed and fear are at odds with one another, a firm reliance on conscience can be your best friend. Pinocchio's conscience was a cricket that traveled around on his shoulder. Jiminy Cricket helps us chart life's course, too, by whispering truth in our ears: "Always let your conscience be your guide." Conscience steers us through lots of important things. The political environment—love it or hate it—isn't going to cause the world to split into two. We know this. The oxygen in our atmosphere won't just float off to Mars. And the markets will endure pretty much anything we throw at them, just as they always have. Life often boils down to simple yes or no questions: Eat the cheeseburger or have the salad. Take the stairs or ride the escalator. Walk for an hour or sit on the couch. (However, fans of *THE GODFATHER* know we should both leave the gun *and* take the cannoli.)

Conscience is a powerful tool. It tells us what to do when we are conflicted, even when that action is at odds with what our emotions tell us we ought to do. I remember reading a prominent *Wall Street Journal* article by Warren Buffett in the fall of 2008, at the height of forecasts about the stock market's impending doom. The article was titled, "Buy American, Because I Am." Buffett wasn't touting the benefits of owning a Ford over a Toyota. He was talking about owning a piece of American business at the very time when fear was telling investors to do otherwise. In essence, he was promoting the wisdom of buying stocks at a time when their prices were temporarily disconnected from reality. "Is he old, senile, and crazy?" a client asked me. With the absolute clarity of hindsight, it turns out the answer was a definitive "no." Buffett was exactly right. In order to capitalize on the markets in 2008, you needed to do something counterintuitive: *Buy* when everyone else was *selling*.

In our opinion, markets like the ones we saw in 2008 and 2009 won't be knocking on our doors anytime soon. But the pullback in late 2018 is a typical example of how markets can react to news items that may not have much gravitational pull in the financial framework of our economy. We survived it. We'll survive the next one, too. I've heard it said, "There is no such thing as smart *money*, just smart *people*." It's true.

Volatility can be unsettling. To that end, in this issue we've also written about the Plan B of a bond portfolio. While bonds haven't necessarily made people rich during this bull market, they did provide a wonderful backstop when clients needed money during periods of depressed equity prices. They worked their magic just as we hoped they would. Volatility happens, but it is investor reaction that matters.

We have a number of client relationships at our firm, and we truly appreciate them all. We are honored that you have confided in our staff and advisors during periods of stress, happiness, sadness, relief, and grief. Years ago, a veteran advisor counseled me, "Knowing economics and the markets is a good thing, but you really ought to do a minor in psychology if you want to be great at this business." I didn't really understand his advice. I plunged headlong into my college courses and books about stocks, bonds, options, the monetary system, banking, and the financial markets. "I am going to manage *money* for a living, *not* people," I told myself. I was wrong. People *are* the markets. The markets are just a collection of the efforts and actions of people who buy stocks and people who *sell* stocks. People and their behavior biases have a massive impact on the way markets behave.

Jiminy Cricket gave sage advice to Pinocchio—he's tiny, but his presence is constant and powerful. Jiminy, if you remember, also sang about living to be one hundred and three. We bet he would have liked buying stocks when there was panic in the streets, too. **OM**

Christopher M. Lamb, CIMA®, CTFA®
Managing Partner and Principal

Image: Aerial image, bridge over river, glacial runoff. Southern Iceland.

CALCULATING BASIS

Is it important to know the cost basis of your investments for tax and performance evaluation purposes? It's essential. Is there nuance in the way basis is calculated? Absolutely.

Written by: Christopher M. Lamb, CIMA, CTFA

The cost basis of an investment is basically the net after-tax cost of the investment on either a total amount or a per-share basis. Cost basis includes any dividends that were reinvested, and any subsequent investments made after the initial purchase. So basis can be a tricky thing to calculate, especially when you've held an investment for a very long period of time. It's even more complicated when you receive assets as a gift or through an estate settlement process.

Why is cost basis important? Apart from revealing how an investment is actually performing, it's a way to judge the amount of profit you may have within a specific investment. Additionally, basis helps you determine potential tax consequences; once an investment is sold, you may owe tax on the profit you've realized above and beyond your basis. Let's explore a few nuances of calculating basis.

Mutual Funds. Mutual funds have gained in popularity and are held by the vast majority of investors as a part of their portfolios. Most mutual fund investors choose to reinvest their dividends in purchasing more shares of their fund. People often believe that if dividends are not received directly by the shareholder, they are not taxable until they are withdrawn from the investment. This is not true.

As an example, assume a client purchases $100,000 of the ABC fund. Assuming a 3% dividend is paid during the course of the year, the investor should find that their new cost basis is $103,000. This includes the original investment along with the additional dividends that were reinvested. According to IRS rules, the dividends received and reinvested add to the investment, and as a result, the dividends are added to the cost basis of the holding.

Mutual funds can be an interesting investment. They pay dividends in a variety of different ways—dividends, interest, and capital gain distributions. All of these items, assuming reinvestment, will add to a mutual fund's basis and will be reflected accordingly on your investment statement.

Gifting Charitable, Non-Charitable. Basis is even more important to people who are able to itemize on their tax returns and have an interest in giving stocks and funds directly from their accounts to charitable entities.

Gifting to charitable entities should be done by isolating the positions within your taxable account—such as your trust, individual, or joint account—that have a low basis and a high value. Essentially, clients should strive to give assets that have the highest level of gain as a percentage of their basis to charitable entities. Investors who hold individual common stocks, as opposed to mutual fund shares, can even allocate shares for the purposes of making charitable gifts based on specific tax lots that may have been purchased at different times during the life of the investment. In this way, investors can retain shares with a low

Image: Wintertime in Leelanau County.

Image: Aerial image. Forty Mile Point, Lake Huron. Presque Isle County, Michigan.

amount of embedded tax cost, while gifting shares that would carry a high tax cost to the investor if sold.

A real-world example: If you give assets to a child during your lifetime, as opposed to passing them along as a part of the estate settlement process, the original cost basis will be retained as a part of the gift. So, let's assume you made a $1,000 investment in Microsoft stock 20 years ago. That investment now carries a value of $25,000 with an embedded taxable gain of $24,000. If you give that investment to your son or daughter, they retain your original investment basis of $1,000. So if they subsequently sell the investment, they will have a taxable gain of $24,000. The original basis of $1,000 is gifted along with the position.

Bear in mind that assets with a gain will carry the basis from the gift giver to the recipient. Assets with a loss follow a slightly different rule. Losses are not carried along with the gift; their basis is reset based on the value of the gift on the date the gift is received. In short, you can't gift stock with a loss to your son or daughter and expect that they will be able to utilize that loss for their benefit.

Inheritance. Inheriting assets as a beneficiary can complicate things even more. Some assets are entitled to an adjustment to their original basis due to the fact that you've inherited the assets. At the time of death, an asset can receive either a step up or a step down in basis depending on the value at the time of death.

Continuing with our example, if your children inherit your Microsoft stock with an original cost basis of $1,000, rather than receiving it as an outright gift during your lifetime, and subsequently sell it for $25,000, your children will receive the entire gain of $24,000 without any tax liability. The basis in this example would have stepped up to the value at the date of death, and no gain would be realized. This benefit does not extend to assets held within annuities or retirement accounts.

Real Estate. Basis calculations are also important when considering the tax consequences of selling homes and other real property. Special rules concerning the sale of a principal residence can reduce or entirely eliminate the taxable gain on that residence. Up to $500,000 in profit for joint taxpayers, or $250,000 for single owners, can be considered tax free, provided the owners pass two tests: first, the property has been owned for at least five years; and second, the property has been occupied for at least two of the five years as a primary residence.

Basis is important in determining taxable gain on any home sale, including vacation homes. Improvements like a new roof, furnace, carpet, flooring, and any other renovations can be added to your original purchase price as an increase to your basis. Utilities and real estate taxes do not apply, however. If you plan to sell a vacation home, it's important to continually maintain a record of the improvements you make, since they add to your non-taxable basis after sale of the asset.

Basis and Performance Assessment. We should never evaluate the success of an investment using basis alone. Capital gain distributions from mutual funds result in an inflated basis and provide an unflattering picture of an individual fund's performance. In situations like this, it's important to consider the original investment, along with any subsequent "hard dollar" investments, when determining the gain or loss within the specific fund. Capital gain distributions do not generate any financial benefit for the investor, but do carry a tax cost if held outside of a retirement account.

> "We Should Never Evaluate The Success Of An Investment Using Basis *Alone*."

Reporting. If this discussion has caused your head to hurt, it's important to understand that the investment custodian—in our case, Fidelity Investments—will automatically calculate cost basis for you during the lifetime of the investments you hold. After investments are sold, the gain is reported on your specific tax documents that relate to the activity within your account. However, for non-brokerage investments like real estate, the IRS requires you to report the basis, and it's also up to you to substantiate your basis calculation in the event that the IRS audits your tax return.

Basis is a tricky little item. Taking into account cost basis as it applies to dividends, interest, capital gain distributions, subsequent investments, gifting, and inheritance situations, it's no wonder most investors remain truly confused about the rules and nuances of basis calculations. **OM**

UPSTREAM GIFTING.

Can you give assets to a parent? Sure thing. And in some cases, there's good reason to consider it.

Written by: Christopher M. Lamb, CIMA, CTFA

Gifting isn't what it used to be. In the past, parents gave financial gifts to their children with the goal of reducing their taxable estates. Today, estate exemptions permit individuals to give almost $11.5 million tax free to their beneficiaries during their life and/or at the time of their death. As a result, gifts and the way they should be structured have changed dramatically.

Traditionally, parents give assets to their children or grandchildren in downstream gifts. Upstream gifts are the opposite: children give assets to their parents, thereby avoiding capital gains taxes, and plan that the assets will be returned to them as part of a tax-free estate. True, this method of gifting strikes a macabre tone by using a parent's death for personal gain. However, the significant advantages of this accepted planning technique make it worthy of consideration for many families.

What are the mechanisms that permit upstream gifting? First, assets that you hold at the time of your death are permitted a step up in their basis. As an example, if you paid $50,000 for your home in 1960, and upon your death it is valued at $1 million, your children or your trustee can sell the home, and the government will essentially erase the $950,000 in profit realized by the sale. The basis in this situation would step up to the value of the home on the date of your death. This step up in basis is a generous government benefit that we all can access, regardless of our relative wealth. The ability to wipe clean a substantial amount of profit upon the sale of an asset is incredibly valuable.

You can give assets to your beneficiaries in a variety of different ways. First, you can give cash—no different than writing a check like your grandmother did for your birthday cards, only much bigger. The funds are received by the recipient and the gift is complete. You can also give assets on an in kind basis, which is simply the transfer of ownership of something like a stock or a piece of real estate. The tax laws require that the basis of an in kind gift will also be transferred from the person giving the gift to the new owner. At the time the gift is made, the unrealized gain is not taxable to the recipient. However, an embedded capital gain is carried along with the asset. If the asset is sold during the lifetime of the new owner, the tax bill comes due for the profit in excess of the original owner's cost basis. However, based on the step up rules, if the asset is not sold during the new owner's lifetime, this gain will ultimately vanish when the new basis becomes the asset's value upon the death of the new owner.

What assets qualify for this powerful planning strategy? Real estate assets, stocks, business interests, and LLCs are the most common assets involved in upstream gifting. Assets that are not eligible are things like traditional IRA accounts, 401(k) plan accounts, annuity contracts, and savings bonds. Any asset largely regarded as a tax shelter does not qualify for a step up in basis and ultimately cannot be gifted.

Let's take the family cottage as an example. Mom and dad thought it would be a good idea to give the family cottage away to their children during their lifetime, so the children now own the cottage. The family cottage was purchased by mom and dad in 1955 for a total of $50,000. It now carries a value of $1 million. The children essentially have an embedded taxable gain of $950,000 that would be taxable if they were to sell the property. The parents have done well during their lifetime and have managed to save $3 million, well below the $11.5 individual estate tax exemption, and the $23 million exemption for a couple. The family decides to use upstream gift planning and the cottage is given back to mom and dad. Upon their passing, the asset receives a new basis and the $950,000 gain is reduced to zero. Since mom and dad were able to include the cottage in their estate and remain below the estate tax exemption limit, the step up applies without adverse tax consequence to the family. And now the children can sell the asset if they choose to do so without any problematic capital gains taxes.

Image: Aerial image, skate skiing during the Vasa Ski Race. Grand Traverse County.

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JOINT PROPERTY (ctd.)

The pitfalls of holding joint property when taking your estate and trust plans into consideration.

medical emergency or job loss. The co-owner could also have an addiction you might not know about when their name is added. For example, dad adds son to his bank account so son can pay bills while dad is in Florida for the winter. Son, unknown to dad, has a gambling issue. After losing money at a gaming table, he dips into the bank account. He has every intention of putting the money back as soon as he wins again. Dad is out of luck unless son's luck changes and he is able to put the money back.

Tax Implications. Creating a joint tenancy with a non-spouse may trigger an immediate gift tax depending on the type of property conveyed. Transferring real estate will trigger gift tax on one half of the value of the property transferred. A gift tax return will have to be filed; however, you can use your annual gift tax exclusion which currently is $15,000 per year. Conversely, when transferring a brokerage account or bank account into joint ownership, no gift is deemed to have been made until the co-owner withdraws money for their own benefit.

Importantly, assets held in joint ownership forego the benefit of a full step up in basis upon the death of the original owner. This is particularly painful when the asset is highly appreciated. Instead of your heir getting a fully stepped-up asset, they are left with only half of that benefit. As a result, if they sell the property, they will be subject to an unintended capital gains tax that could have been avoided with better planning.

Before transferring property into joint ownership, be sure to consider the full range of potential consequences. Although the transfer process is inexpensive and straightforward, it is also a simplistic approach that frequently leads to unintended results that can cost time and significant expense to correct. In the long run, it pays off to sit down with an experienced financial planner who can assist with the best solutions for your specific situation. **OM**