

*Let me tell you how it will be;  
There's one for you, nineteen for me.  
'Cause I'm the taxman,  
Yeah, I'm the taxman.*

*Should five per cent appear too small,  
Be thankful I don't take it all.  
'Cause I'm the taxman,  
Yeah, I'm the taxman.*

*If you drive a car- I'll tax the street;  
If you try to sit - I'll tax your seat;  
If you get too cold - I'll tax the heat;  
If you take a walk- I'll tax your feet.*

George Harrison of the Beatles, *Revolver*, 1966

### { The Taxman Cometh }

For most of us, the idea of higher taxes is anathema. In fact, we have been living in a golden age since President Ronald Reagan had the foresight to lower taxes as part of the Tax Reform Act of 1986 nearly a quarter of a century ago. Some pundits, including the author, may argue that the growth experienced in the late '80's and most of the '90's was a direct result of the more favorable tax environment which reallocated capital from the less efficient users (the government) to the more efficient users (the private sector) by creating incentives for individuals and corporations alike to invest.

Well, let's all have a moment of silence for the end of an era. Taxes will rise. You can bet on it. The first step in that direction comes in the form of the sweeping healthcare legislation, the Patient Protection and Affordable Care Act (along with its amendment Health Care and Education Reconciliation Act of 2010) passed by the federal government. While a lot of the specifics remain to be determined, it seems to be an opportune time to provide a brief overview of the Act's terms and offer some initial thoughts regarding the impact to investors. We will also review certain other measures being considered that may affect your investment and wealth management strategies. Keep in mind that due to the Bush tax reforms, the tax code has become a collection of expiring provisions that require advisors and investors to stay apprised of the many changes expected over the coming year.

#### INVESTMENT INCOME WILL FUND HEALTH CARE

To fund healthcare reform, beginning in 2013, a 3.8% surcharge-tax, in addition to existing investment taxes, will be assessed on investment income such as interest, dividends, rents and capital gains. This surcharge applies to individuals with adjusted gross incomes (AGIs) above \$200,000 and couples with AGIs above \$250,000. The legislation also raises the ordinary Medicare payroll tax by 0.9% for the same filers, bringing it to 3.8%. Fortunately, interest income from municipal bonds is excluded from the new Medicare tax.

#### BACK TO THE FUTURE - GOODBYE BUSH TAX CUTS

President Bush (#43), similar to Reagan, took the opportunity to enact a number of changes to the tax system resulting in lower taxes across the board – most notably, lower marginal tax rates, lower rates on dividends and capital gains, and higher thresholds to assess estate, gift and generation-skipping transfer taxes. However, the sunset provision means that all of these changes made will expire at the end of 2010. As such, the federal government is not required to do anything in order to increase taxes in 2011 since taxes will automatically return to pre-2001 rates. If you don't remember what those were, highlights (or low-lights, depending on your perspective) include:

- Highest marginal tax bracket, 39.6%, applied to earned, dividend, and interest income as well as short term capital gains. If there is any silver lining, it appears that qualified dividends may be capped at 20%. Non-qualified dividends would be taxed at the earned income rates.
- Long-term capital gains taxed at 20%, instead of the current 15%.
- The estate and GST exemptions were each at \$1 million, and the top estate, gift, and GST tax rate was 55%. While Congress has yet to pass a bill, there have been proposals to freeze the estate and GST tax exemptions at \$3.5 million for each individual or \$7 million for married couples (the 2009 levels) and to establish the top estate, gift, and GST tax rate of 45%, thus providing for some form of reprieve.

There are some other ideas being discussed such as extending the alternative minimum tax exemptions adopted for 2009 and indexing them to inflation going forward.

Ultimately, the top federal marginal tax rate affecting income and short term capital gains will climb to 43.4% in 2013 when combining the federal tax rate and the Medicare surcharge. Add in state tax rates, and, needless to say, we are going to experience a big jump in our tax bills!

#### GRATS

In pursuit of tax revenues, Congress and the President have set their sights on Grantor Retained Annuity Trusts or “GRATs.” By way of background, a GRAT is an irrevocable trust designed to allow the donor to transfer assets into the trust and retain the right to receive back an annuity for a term of years, thus enabling the donor to receive an annual payment for a fixed period equal to the value of the assets contributed plus interest at a rate set by the IRS each month. At the end of the GRAT term, any remaining value in the trust (i.e., the appreciation and return on the assets exceeding the IRS rate during the GRAT term) will pass to the remainder beneficiaries of the GRAT free of transfer taxes. However, if the donor dies before the end of the GRAT term, some or all of the GRAT assets will be included in the donor's estate for estate tax purposes. The primary tax benefit – the tax-free transfer of the GRAT remainder interest after the trust term ends – is derived from the fact that the initial gift value of the remainder interest upon the formation of the GRAT was designed to be zero because the total annuity payments to the donor were expected to equal the amount originally contributed, plus interest, thus resulting in no taxable gift. Until now, many donors chose to fund GRATs with highly volatile assets which were expected to increase over a short period of time, resulting in the excess of the principal that could pass to the beneficiaries transfer tax free.

In President Obama's fiscal 2010 and 2011 budget proposals, he has suggested limiting GRATs with a focus on extending the minimum term to ten years with the expectation of raising \$4.45 billion in incremental tax revenues over that time period. Today, most GRATs are structured with two to three year terms. On March 29, 2010, the House of Representatives passed H.R. 4849 – a bill containing several anti-GRAT provisions which severely limit the ability to hedge the mortality and investment risks

associated with the use of the short-term GRAT, including a minimum ten year term and the requirement of a specific value for the remainder interest which must be “greater than zero” at the creation of the GRAT. Nevertheless, changes to H.R. 4849 could still take place prior to final enactment which is awaiting Senate approval. As stated above, the benefit of the GRAT can only accrue to the beneficiary if the donor survives the term. With terms being extended to a ten year minimum, the donor may need to consider adding an insurance policy to his or her estate plan to hedge the increased mortality risk.

#### IMPLICATIONS OF TAX CHANGES TO INVESTMENT PORTFOLIOS

With all of the potential changes to the tax regime, it is appropriate to consider the effect of these changes on investment portfolios. There are many, including the following:

- **Cash Investments:** Tax-exempt money market funds will become increasingly more attractive relative to Government and Prime money market funds. Risk aside, investors in the highest tax bracket would benefit by investing in tax-exempt money markets on an after-tax basis if the yield were at least 56.6% ( $1 - [\text{tax rate}]$ ) of the equivalent taxable money market fund.
- **Fixed Income:** For high quality fixed income, where little capital appreciation is expected and returns are driven almost exclusively by income, the same rule as for cash investments would apply. For fixed income investments where there may be some expectation of capital gains contributing to returns, such as high yield bonds, the tax bite as a percentage will be less, given their capital gains potential, and may make them suitable for diversification and after-tax return contribution for taxable investors at times when they trade for less than par value.
- **Multi-Strategy Hedge Strategies:** Funds employing arbitrage trades where a significant portion of returns are either short-term capital gains or income will be among the most heavily impacted by higher taxes. There are funds in this space which may be more efficient, such as those employing distressed debt strategies or event-driven strategies, where a more significant portion of their return may be long-term capital gains. Despite the lower tax-efficiency, the diversification value of these strategies may still justify their use.
- **Equity:** Managers that manage their portfolios with a high level of tax awareness, making efforts to hold investments until they reach long-term status, holding dividend paying companies long enough to ensure their “qualified” status and regularly harvesting losses (particularly short-term), will add value to a portfolio. Tax-managed index strategies will become even more attractive on an after-tax basis. This begs the consideration of whether active management should be utilized at all in asset classes where a manager’s ability to outperform an index is challenged and the magnitude of outperformance on a pre-tax basis for the most successful of managers is minimal. Exchange traded funds (ETFs), because of their structure, have historically been able to minimize distributions and therefore are generally considered very tax-efficient.
- **Directional Hedge Strategies:** Many long-short equity hedge managers are not cognizant of the tax implications of their strategies. Generally, the managers that run a significant portion of their own taxable assets are more cognizant and tend to run more tax-efficient portfolios. This is an asset class where each manager needs to be evaluated individually as their performance after-tax will vary dramatically.
- **Private Equity:** Private Equity has long been one of the more tax-efficient asset classes as income is kept to a minimum and holding periods tend to be long, therefore creating an asset that tends to produce mostly long-term capital gains. Private Equity will become more attractive relative to other strategies that have exposure to short-term gains and income generation.
- **Real Estate:** Real Estate comes in many different structures, public vs. private, REIT (real estate investment trust) vs. REOC (real estate operating company), and each has its own unique tax treatment. Starting in the public realm, REITs, which pay out significantly all of their income

generated, are taxed at regular income tax rates as these are not considered qualified dividends. Conversely, REOCs are not required to distribute their income and when they do it would be in the form of a qualified dividend, and therefore more tax-efficient to investors. The tax efficiency of Private Real Estate partnerships varies depending on their approach and structure, but they are generally also more tax efficient than REITs.

- **Commodities:** Investing in commodities via equities is a relatively efficient way to access the asset class. Investing in a fund that uses commodities futures (treated as 60% long-term, 40% short-term gains for tax purposes) typically is less tax efficient, depending on the underlying collateral held for the futures contract. Most hold either Treasuries or Treasury Inflation Protected securities, which are taxed at standard income tax rates. Some utilize municipal bonds which are more tax favorable, but the decision hinges on whether the tax-equivalent yield is higher than Treasuries. Finally, a unique vehicle, the Exchange Traded Note (ETN) can be used where it is considered (currently) as a prepaid forward contract and therefore is taxed based on maturity or time of sale. ETNs do not typically make distributions generated from underlying Treasury holdings, and that income generated is not taxed along the way. In fact, if the ETN is held more than a year, the net gain once sold is taxed at the long-term capital gains rate.

In addition to the implications noted above, there are some considerations that should be evaluated given the current environment.

- It may make sense to harvest some gains and reset cost basis with the thought that an investor can harvest the gains at lower long-term rates (15% vs. 20%) and also create the opportunity to harvest short-term losses in the future, which could be used to offset short-term gains at the higher tax rate.
- Convergent Wealth Advisors has a powerful analytical tool in PORTAX, a proprietary software package that considers a mean variance optimization, after-tax returns, volatility and correlation among asset classes designed to evaluate the efficiency of all possible portfolios in a risk and return framework. Our analysis of the new tax regime vs. the former tax regime shows that there is a marginal difference in allocation due to the changing tax landscape, but that the more dominant factor remains diversification benefits across asset classes. Generally speaking, the analysis suggests a shift towards more efficient asset classes such as equities (with longer holding periods) and away from taxable fixed income, multi-strategy hedge funds and real assets. It is important to note that the difference in manager selection and investment vehicles can have a significant impact on this outcome.
- Lower after tax returns will result in lower expectations of net appreciation value over time i.e. the Monte-Carlo simulations we review with clients will end up illustrating the potential need to make policy shifts to more aggressive portfolios in order to meet goals (or cut back on spending).

#### CONCLUDING REMARKS

In the end, the key question is, “Will these tax changes affect your strategic asset allocation?” While we seek to maximize after-tax returns for our investors, we don’t anticipate making major changes to our long-term asset allocation strategies. As discussed above, tax considerations will manifest themselves mostly in the execution of that asset allocation through targeted manager selection, as well as sound estate planning and asset location. Finally, it is important to note that good investment decisions should always take precedence over tax considerations. If you have any questions regarding potential changes to the tax structure and its impact on your portfolio, please contact your advisor.

*See following page for disclosures.*

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