



# MARKETING INTELLIGENCE

Report

## Investing in a Rising Tax Environment

A year after President Obama has taken office, the federal deficit has ballooned to more than four times its previous high. Federal expenses have swelled as the government has expended funds to support financial institutions, stimulate the economy, and provide benefits to out-of-work families. At the same time, federal tax revenues have suffered the greatest year-over-year decline since the Great Depression.

To address this mounting deficit, the president has asked Congress to approve a tax increase on affluent families. The president is proposing permitting the Bush tax cuts to expire on schedule at the end of 2010, but only for families with taxable income over \$250,000 (individuals with income over \$200,000). Under the president's plan, the top tax rate on ordinary income will rise from 35% to 39.6%, the top capital gains rate will rise from 15% to 20%, and the top tax rate on dividends will rise from 15% to 20%. The president also has proposed limiting itemized deductions claimed by these taxpayers to a 28% rate (a proposal Congress rejected last year).

Congress this year enacted a sweeping national health care program, the largest social program in many decades. To finance the program, Congress approved an additional 0.9% tax on employment compensation in excess of \$250,000 (\$200,000 in the case of individual taxpayers), and an additional 3.8% tax on taxable investment income earned by families with adjusted gross income above \$250,000 (\$200,000 in the case of individual taxpayers). These new taxes are scheduled to take effect at the beginning of 2013, raising the top tax rate on ordinary income at that time to almost 44% and the top tax rate on capital gains and dividends to almost 24%.

Finally, additional tax revenues are likely to be needed to finance mounting federal expenditures. The federal deficit was projected to grow significantly, even before incurring the additional costs of economic stimulus, financial crisis remediation, and health care reform. Social Security and Medicare outlays are projected to increase dramatically in coming years to meet the needs of aging baby boomers. Interest payable on the inflated national debt also is projected to grow significantly. Meeting these expenditures could require more new taxes, the bulk of which likely would be borne by higher income families.

By taking action this year, investors may be able to blunt some of the effects of a future tax increase. Some options to do so are reviewed below. Investors should not necessarily undertake any or all of these steps now. In many cases, it will make sense to consider them as we learn more about the future course of tax legislation. In the meantime, investors should review these steps with their financial professionals, as well as their attorneys and tax advisors, and begin to discuss whether — and when — they could make sense in their particular circumstances.

*Andy Friedman recently provided a Washington Update at M Financial Group's 2010 National Advisors Conference. The following article details insights on political and legislative developments that Andy shared at the meeting, as well as important information on investing in a rising tax environment.*

# Investing in a Rising Tax Environment

## Step One — Sell assets to take advantage of existing capital gains rates

Investors with long-term gains in their assets should consider selling and recognizing the gain before the top applicable tax rate rises from 15% to 20%. A recent study determined that, if asset values increase by 8% per year and the capital gains rate increases from 15% to 20%, an investor will have to hold assets for at least an *additional five years* to be better off than had he sold the assets initially and paid tax at the lower rate.<sup>1</sup>

Investors likely will be able to obtain the lower capital gains tax rate by selling at any time this year. But investors should keep an eye on the tax bill as it moves through Congress, as Congress conceivably could move up the effective date to avoid a year-end sell-off. If this happens, investors likely will have time to sell assets traded on an established exchange. But they might not have time to sell non-marketable assets such as real estate or a business. Investors selling those types of assets might want to consider a sale earlier in the year rather than later.

By selling this year, investors can lock in gains realized during the run-up that occurred in 2009. They then can consider redeploying the funds realized on the sale to investments that offer stable growth and downside protection. Other investors who wish to keep their investments can sell a security, recognize the gain, and immediately repurchase that security to reestablish the position. The “wash sale” rule, which requires investors to wait thirty days before repurchase, applies only to recognition of *losses*, not gains.

## Step Two — Receive ordinary income currently rather than in a later year when tax rates may be higher

With ordinary income rates expected to rise, investors might wish seek to receive additional taxable income currently rather than in later years. For instance, executives could consider exercising non-qualified stock options this year so that the resulting income will be taxed at prevailing rates.

## Step Three — Defer discretionary deductible payments (such as charitable contributions) to later years when they may be worth more due to higher tax rates

The tax benefit of a tax deductible expenditure increases as tax rates increase. If a tax rate increase is expected, it may be worthwhile to defer deductible payments until the higher rate takes effect. For instance, at the current top federal tax rate, a charitable contribution of \$100 yields a benefit of \$35. If the federal rate rises to 40%, making that contribution next year will save \$40 in taxes.

Investors considering charitable contributions are advised to wait until the latter part of this year. If the president’s proposed 28% limitation on charitable contributions passes Congress, the investor will want to go ahead and make the contribution this year, before the new limitation takes effect. If, however, the limitation does not pass, the investor may wish to defer the contribution to next year, where it can offset income that otherwise would be taxed at a higher rate.

## Step Four — Give increased consideration to municipal bond investments

As tax rates increase, demand for municipal bonds increases, as more people wish to avoid tax. Similarly, as tax rates rise, the effective interest rate on municipal bonds increases. For instance, a municipal bond paying 3% interest pays a tax-equivalent yield of 4.6% in a 35% tax rate environment. But if tax rates rise to 40%, the tax-equivalent yield on the same bond rises to 5%. In short, all other things being equal, rising tax rates can signal rising municipal bond values.

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At the same time, the supply of tax-exempt municipal bonds is shrinking, as more states issue Build American Bonds, authorized by last year's stimulus legislation. Build America Bonds pay a higher rate of interest that is taxable to the holder. (For this reason, BABs can be particularly good investments for IRAs.) Increased demand coupled with reduced supply could have a favorable effect on the municipal bond market.

### Step Five — Give increased attention to harvesting losses and buy-and-hold investment strategies

As the tax rate on capital gains increases, the tax deferral afforded by buy-and-hold strategies becomes more valuable. Similarly, it becomes more important to harvest tax losses to shelter gains that otherwise would be taxed at the higher rate.

### Step Six — Consider tax-efficient mutual funds and other professionally managed tax-advantaged investment strategies

A rise in tax rates can meaningfully reduce the net returns provided by tax-inefficient investments. In a rising tax environment, a tax management strategy that seeks to enhance after-tax return by balancing investment and tax considerations becomes increasingly important.

Tax management techniques include purchasing stocks with a long-term perspective to delay recognition of taxable gain, reducing turnover to minimize short-term gain, investing in stocks that pay qualifying dividends, harvesting tax losses, and selectively using tax-advantaged hedging techniques as an alternative to taxable sales.

Similarly, investment strategies that manage or defer taxes, such as exchange funds, provide increasingly greater benefits as tax rates rise.

### Step Seven — Consider investing in annuities and life insurance that offer tax deferral

Life insurance provides tax deferral on unwithdrawn increases in cash value during life and a tax-efficient way to pass wealth to future generations. If the policy is held until death, the death benefit is not subject to income tax, and if properly structured, may also be free from estate tax. These tax savings increase as tax rates increase.

Today, many investors are turning to variable annuities to provide tax deferral, guaranteed lifetime income, the potential of equity upside, and a death benefit for heirs they name as beneficiaries. The owner of a variable annuity invests assets in a choice of investment options offered by the annuity issuer. Earnings on those assets accumulate tax-deferred until distributed. When withdrawn, income is taxed at ordinary rates (and if taken prior to age 59-1/2 may incur a tax penalty). The owner can choose to receive payments from the annuity guaranteed for life.

Depending on the contract terms, for an additional fee a contract owner may irrevocably elect an optional guaranteed minimum withdrawal or income benefit rider. A "guaranteed minimum withdrawal benefit" (GMWB or MGWB) provides a safety net for retirement assets — no matter how those assets perform — by guaranteeing that the contract owner can withdraw annually for his lifetime an amount (typically 4% to 6%) of no less than his original investment (provided he does not withdraw more than the guaranteed amount in any year). If this benefit is elected, an increase in the value or the underlying assets will result in a higher annual payment (4% to 6% of the higher number). But this annual payment will never go down, even if the asset value later declines or the contract owner lives longer than expected. Thus, in essence, the holder receives a guaranteed annual payment based on the "high water mark" of the underlying asset value, as computed under the terms of the annuity contract.<sup>2</sup>

When the owner of an annuity contract dies, the assets remaining — and perhaps more if the contract owner for an

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additional fee has elected a guaranteed minimum death benefit rider — are paid to his designated beneficiaries. An enhanced annuity death benefit may be particularly useful for an individual who cannot purchase life insurance for health reasons. Unlike death benefits paid by life insurance, annuity death benefits are subject to income tax, although a beneficiary can choose to defer that tax by “stretching” the payment of the annuity death benefit over his life. In a rising tax environment, the tax deferral feature of annuities becomes increasingly valuable.

### Step Eight — Convert a traditional IRA to a Roth IRA

Roth IRAs give investors the opportunity to realize future investment earnings tax-free. Particularly in an era of rising tax rates, this feature can provide significant value.

Beginning in 2010 all individuals are eligible to convert their traditional IRA to a Roth IRA. Taxpayers who expect to be taxed at the same or a higher rate in future retirement years should consider this option seriously.

If assets have been held in a Roth IRA for at least five years and the account holder is at least age 59-1/2 (or has died or become disabled), then all Roth withdrawals — including withdrawal of earnings — are received entirely tax-free.<sup>3</sup> Moreover, while assets held in a traditional IRA must begin to be distributed when the holder turns age 70-1/2, no such distribution rules during life apply to a Roth IRA. Rather, a Roth IRA holder may choose to maintain assets in the Roth, where they can continue to accumulate tax-free.

Post-death distribution rules do apply to a Roth IRA in the same manner as to a traditional IRA. Thus, at death the Roth balance must be distributed to a named beneficiary within five years or over the beneficiary’s lifetime. (Spousal beneficiaries are exempt from this requirement and may continue their deceased spouse’s Roth IRA intact.) All distributions made to the beneficiary from the Roth retain their tax-free character, so that the beneficiary, like the original Roth holder, receives the Roth assets entirely tax-free.

When the holder of a traditional IRA converts to a Roth, he/she recognizes taxable income on the previously untaxed value of the converted IRA in the year of conversion. If the conversion occurs in 2010, however, the holder may pay this tax half in 2011 and half in 2012 at the rates in effect in those years, or pay the full tax in 2010 at 2010 rates. (Given the proposed tax rate increase scheduled to take effect in 2011, the latter option may make more sense.) Amounts converted after 2010 are subject to tax fully in the year of conversion. The holder may choose to convert all of his traditional IRA to a Roth in a single year, or to convert only a portion and decide when to convert additional portions in later years.

The holder typically pays the conversion tax with non-IRA funds. (If he/she uses IRA funds, amounts withdrawn to pay this tax are subject to income tax and may also be subject to a 10% penalty.) Paying this tax with outside funds in effect provides an additional contribution to the Roth IRA, as the assets in the IRA account remain the same, but now all future taxes on those assets have been paid.

Choosing the proper investment for a Roth IRA can enhance its value. For instance, many holders are purchasing variable annuities in their Roth IRAs. As discussed above, variable annuities with optional income benefits can provide guaranteed lifetime income that increases as investment assets increase but does not decline if asset values go down (provided no excess withdrawals are taken). Where the annuity is held in a Roth, this guaranteed income stream is entirely tax-free. Moreover, when the Roth IRA holder dies, the annuity death benefit is available to the IRA beneficiary, who may “stretch” the payment of that benefit and receive payments over his lifetime. Those lifetime payments to the beneficiary — like the payments to the original Roth investor — are tax-free. Thus, a variable annuity purchased with Roth IRA funds can provide tax-free income to two generations.

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*To access Andy's other white papers and periodic legislative updates, visit [TheWashingtonUpdate.com](http://TheWashingtonUpdate.com)*

<sup>1</sup> *Pay Now or Later? Making Investment Decisions in a Changing Tax Environment, Parametric Portfolio Associates, LLC (Spring 2008).*

<sup>2</sup> *If the holder later elects to "annuitize" the contract (that is, to irrevocably elect equal periodic payments for his lifetime), the annuity benefit will be the higher of the GMWB payment or the base contract annuitization amount. Refer to the contract prospectus for additional information.*

*A "guaranteed minimum income benefit" (GMIB or MGIB), available for an additional charge, is similar to a GMWB. The holder is guaranteed to receive a minimum annual payment for life. These payments are based on conservative actuarial factors that are currently less favorable than the payout rates used to convert contract values to annuitization income. Refer to the contract prospectus for additional information. All guarantees are based on the claims paying ability of the issuing life insurance company.*

<sup>3</sup> *If the five year tax holding period is not met, then withdrawals of earnings from the Roth IRA are subject to tax. However, in that case withdrawals are treated as coming first from non-taxable contributions and previously taxed amounts; only after those amounts are withdrawn is tax imposed. If the holder is not over age 59-1/2 (and does not meet one of the other exceptions), then withdrawals of earnings, and of amounts converted from a traditional IRA within the prior five years, also are subject to a 10% penalty tax.*

## For More Information

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