

# Navigating Through an Evolving Tax Environment

## *Guidelines to Help High Income Taxpayers Make Well-Informed Decisions*

Gross federal debt has reached a record \$14 trillion and the federal deficit has ballooned to more than four times its previous high.<sup>1</sup> In order to maintain current government services and entitlement programs, policymakers and politicians may be tempted to raise additional sources of revenue to service this debt.

*... take precautions now,  
but “don’t let the tax tail wag  
the investment dog.”*

As a result, income, estate and health care tax policies are changing, and high income taxpayers may be asked to shoulder more of the burden. These tax increases may not end with the federal government. Many state and local governments are facing budget deficits as well, and higher tax rates are viewed as one way to increase revenue.

Naturally, the prospect of higher taxes is a concern to the people and families who will be affected. Regardless of individual political perspectives, prudent investors are setting aside their emotions about taxes in order to make smart tax-management choices for their families.

This may be an opportune time to review the current tax laws and learn what laws are set to expire in 2012 without new legislation. This report will provide perspective to help you determine whether adjustments to your portfolio or overall wealth management plan would be practical for tax-management purposes.

By spending a few minutes learning about the relevant facts, you will be ready to have a conversation with your RBC Wealth Management Financial Advisor, your tax professional and possibly your estate attorney. Together, you will be able to make decisions to help reduce your potential tax exposure while still working toward your important wealth management goals. You may even gain a sense of confidence about how you respond to changing tax policies.

At RBC Wealth Management, we believe taking a long-term approach still makes sense — and there is little value in making drastic changes to your portfolio. In other words, take precautions now, but “don’t let the tax tail wag the investment dog.”



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## New Tax Legislation Has Passed

### Two Key Legislative Acts Affect the Evolving Tax Environment:

- 1) The Patient Protection and Affordable Care Act (PPACA) was signed into law on March 23, 2010.
- 2) On December 17, 2010, President Obama signed into law the “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” (Tax Relief Act of 2010). This legislation extended the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) through 2012. These laws are otherwise known as the “Bush Tax Cuts.” To date, no new legislation has been passed to replace either of them.

*Key take away — The Tax Relief Act of 2010 provides a two-year reprieve on potential tax increases; however, as currently enacted rates are set to expire in 2012.*

## Common Questions

### What Are the Health Care Funding Implications?

In 2010, Congress enacted a sweeping national health care program, the largest social program in decades. To finance the program, PPACA calls for taxes and levies on high income people to cover anywhere from 20% to 48% of the cost.<sup>2</sup>

These health care tax increases will take effect in 2013 and would fall almost entirely on the top 1% of high income people and apply to income above \$250,000 for married couples and above \$200,000 for individual taxpayers. Affected taxpayers will see a 0.9% Medicare tax increase on wages and self-employment income and an additional 3.8% Medicare tax imposed on individual net investment income — which includes money received from capital gains, dividends, taxable interest income, rents, royalties and annuities.

However, there is some good news for high income taxpayers. Income from interest on tax-exempt bonds, veterans’ benefits, and gains from the sale of a principal residence that is excluded from gross income is not considered net investment income that falls under the PPACA tax provision. Plus, income from a qualified retirement plan and IRA distributions is not considered investment income under the PPACA.

*To finance the program, PPACA calls for taxes and levies on high income people to cover anywhere from 20% to 48% of the cost.*

*Key take away — Most of the PPACA rules will not take effect until 2013, leaving time to digest the proposals and plan for their impact.*

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## What Are the Income Tax Implications?

The Tax Relief Act of 2010 extended the Bush Administration's ordinary income tax cuts for 2011 and 2012. The federal tax bracket rates are 10%, 15%, 25%, 28%, 33%, and 35%. Taxable interest income (money market, CDs, taxable bonds, etc.) is taxed at ordinary income rates. Without further legislation, the federal tax bracket rates in 2013 will be 15%, 28%, 31%, 36% and 39.6%. The 3.8% Medicare tax imposed on individual net investment income could raise the highest interest income rate to 43.4% in 2013. It is important to note that starting in 2013 these high income taxpayers will also pay a 0.9% surcharge on earned income to help fund provisions of the PPACA.

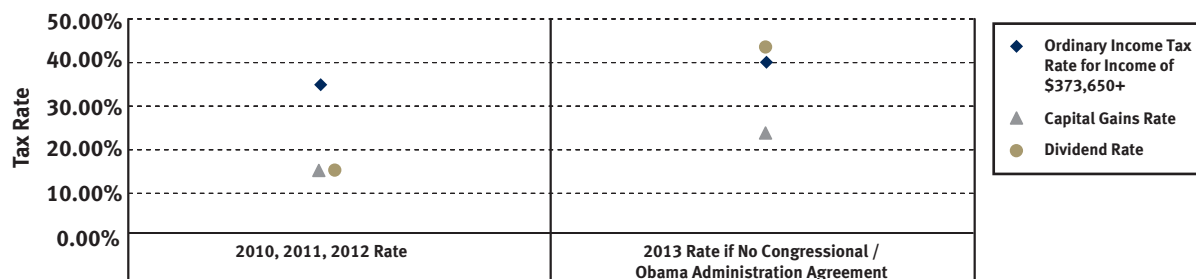
Taxes on income earned from long-term capital gains and qualified dividends will also be changing. While short-term capital gains and ordinary dividends are taxed at ordinary income tax rates, long-term capital gains and qualified dividends have historically offered a discounted tax rate. The Internal Revenue Service (IRS) defines long-term capital gains as earnings on capital appreciation realized when selling capital assets, including securities, held for more than one year. According to the IRS, qualified dividends are ordinary dividends that meet the requirements to be taxed at the same rate as net capital gains because the stock position was established within a sufficient period of time (depending on share class) prior to the company announcing an ex-dividend date.

*To help simplify terminology, throughout the remainder of this report (unless otherwise indicated) usage of phrase "capital gains" will refer specifically to long-term capital gains and usage of the word "dividends" will refer specifically to qualified dividends.*

Provisions of JGTRRA reduced capital gains and dividend tax rates to 15%. At the end of 2012, JGTRRA is set to expire, returning capital gains and dividend tax rates to their 2002 levels. Without new legislation, beginning in 2013 capital gains tax rates will increase to 20% for taxpayers in tax brackets greater than 15%, and dividends will be taxed at ordinary income tax rates. Plus, beginning in 2013 these taxpayers will have a 3.8% health care tax added to capital gains (both long term and short term) and dividend (both ordinary and qualified) income.

The outcome? Without government action by 2013, high income taxpayers will see their total tax paid on dividend income alone jump from 15% to as high as 43.4% — or nearly three times the previous rate for dividend income.

## Federal Tax Policy Scenarios for Highest Income Taxpayers



| Current Tax Rates:      |                       |                |                 |                 |
|-------------------------|-----------------------|----------------|-----------------|-----------------|
| Income Tax              | 2010, 2011, 2012 Rate | 2013 Rate      | Health Care Tax | 2013 Total Rate |
| Ordinary Rates          | 35%<br>33%            | 39.6%<br>36.0% | 0.0%<br>0.0%    | 39.6%<br>36.0%  |
| Taxable Interest Income | 35%<br>33%            | 39.6%<br>36.0% | 3.8%<br>3.8%    | 43.4%<br>39.8%  |
| Capital Gains Rate      | 15%                   | 20%            | 3.8%            | 23.8%           |
| Dividend Rates          | 15%                   | 39.6%<br>36.0% | 3.8%<br>3.8%    | 43.4%<br>39.8%  |

Source: Internal Revenue Service

## Health Care Tax

Health care tax will take effect on January 1, 2013. The health reform legislation increases the Medicare payroll tax on earned income for high-wage individuals (\$250,000 for married filing jointly and \$200,000 for single) by 0.9% (from 1.45% to 2.35%). A 3.8% Medicare contribution tax will be imposed on net investment income (or unearned income) of high-income individuals (\$250,000 for married filing jointly and \$200,000 for single). Net investment income is generally net income from interest, dividends, annuities, royalties and rents, and capital gains, as well as income from a business that is considered a passive activity or a business that trades financial instruments or commodities.

*Key take away — High income taxpayers may experience higher tax rates upon expiration of the Tax Relief Act of 2010.*

## What Are the Estate Tax Implications?

Provisions of the Economic Growth and Tax Relief Act of 2001 (EGTRRA) gradually increased the Applicable Exclusion Amount (estate tax exemption), gradually reduced the estate tax rate through 2009 and replaced the estate tax with a carryover basis system in 2010. Prior to 2010, in general, the basis of estate property was its fair market value on the date of the decedent's death.

The Tax Relief Act of 2010 reinstated the estate tax at a maximum rate of 35% with an estate tax exemption of \$5 million for decedents dying after December 31, 2009 and before January 1, 2013. It also increased the lifetime exemption from \$1 million in 2010 to \$5 million for both 2011 and 2012. This provides significant gifting opportunities for high net worth individuals.

Because the Tax Relief Act of 2010 was not passed until December 17, 2010, the Act provided the executor of the estate to elect out of the estate tax in 2010 imposed by the Tax Relief Act of 2010 and use the modified carryover basis rules that were in place prior to that legislation. If the executor elects out of the estate tax in 2010, the basis of estate property is the lesser of the asset's fair market value on the date of death or the decedent's (carryover) basis. However, two special basis adjustments may apply. The first adjustment allows estates to exempt up to \$1.3 million of appreciation or gain on property that is passed to any beneficiary. The second adjustment allows estates to exempt up to \$3 million of appreciation or gain on property that passes to a surviving spouse.

The Tax Relief Act of 2010 also allows for the portability of the estate tax exemption for 2011 and 2012. The surviving spouse may now use any estate tax exemption that was not used by his or her predeceased spouse. This, however, is limited to the unused estate tax exemption of only the last spouse to die. This allows those individuals who have not created trusts to minimize estate taxes at the death of the first spouse, to not lose the estate tax exemption of the first spouse.

In 2013, under current law, the estate tax exemption will revert back to \$1 million with a maximum rate of 55% according to the law prior to EGTTRA. The chart below shows the changes enacted under EGTTRA and the Tax Relief Act of 2010.

| Estate Tax and Gift Tax Applicable Exclusion Amounts |                      |                 |   |                             |                           |
|--|----------------------|-----------------|---|-----------------------------|---------------------------|
| Year   | Estate Tax Exemption | Estate Tax Rate | Generation Skipping Tax (GST) Exemption | Gift Tax Lifetime Exemption | Gift Tax Annual Exclusion |
| 2002   | \$1,000,000          | 50%             | \$1,000,000                             | \$1,000,000                 | \$11,000                  |
| 2003   | \$1,000,000          | 49%             | \$1,000,000                             | \$1,000,000                 | \$11,000                  |
| 2004   | \$1,500,000          | 48%             | \$1,500,000                             | \$1,000,000                 | \$11,000                  |
| 2005   | \$1,500,000          | 47%             | \$1,500,000                             | \$1,000,000                 | \$11,000                  |
| 2006   | \$2,000,000          | 46%             | \$2,000,000                             | \$1,000,000                 | \$12,000                  |
| 2007   | \$2,000,000          | 45%             | \$2,000,000                             | \$1,000,000                 | \$12,000                  |
| 2008   | \$2,000,000          | 45%             | \$2,000,000                             | \$1,000,000                 | \$13,000                  |
| 2009   | \$3,500,000          | 45%             | \$3,500,000                             | \$1,000,000                 | \$13,000                  |
| 2010 **  | \$5,000,000          | 35%             | \$5,000,000<br>(0% GST tax rate)        | \$1,000,000                 | \$13,000                  |
| 2011   | \$5,000,000          | 35%             | \$5,000,000                             | \$5,000,000                 | \$13,000 *                |
| 2012   | \$5,000,000          | 35%             | \$5,000,000                             | \$5,000,000                 | \$13,000 *                |
| 2013   | \$1,000,000          | 55%             | \$1,120,000 *                           | \$1,000,000                 | TBD                       |

\* Indexed to inflation

\*\* If an executor elects out of the estate tax in 2010, the estate tax is replaced with a modified carry-over basis under EGTTRA.

*Key take away — There is significant opportunity during the next two years to utilize the gift tax exemption of \$5 million to leverage wealth transfer to future generations.*

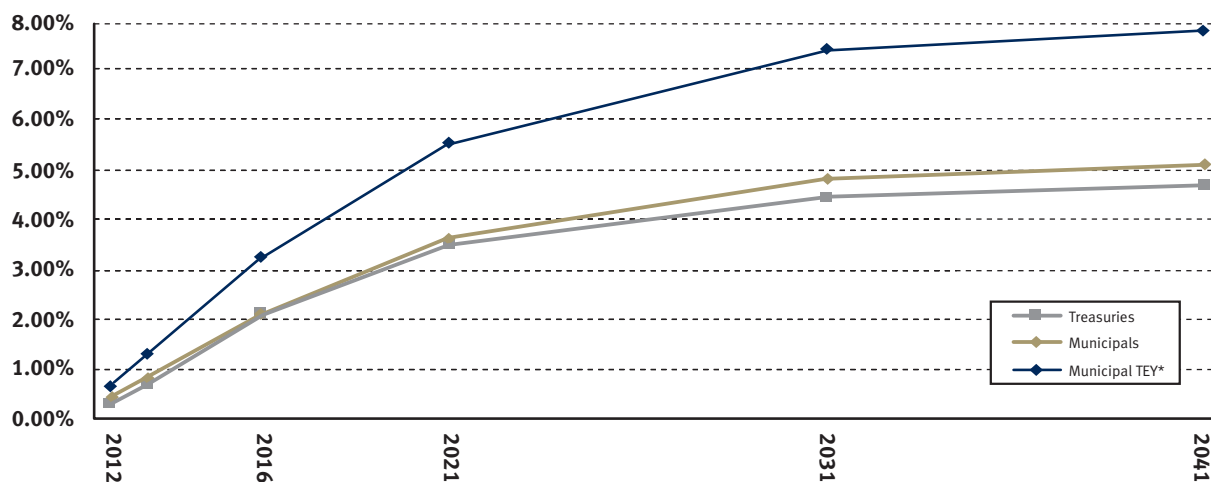
## What Are the Fixed Income Investing Implications?

The Tax Relief Act of 2010 will do nothing to diminish the demand for municipal bonds going forward. Investors in the higher tax brackets will continue to benefit from the favorable tax status of municipal bonds. The expiration of the Build America Bond program should result in increased issuance of traditional tax-free bonds in 2011.

Yields on municipal bonds hit near-generational lows in early November 2010. At the time of this publication, a combination of headline events over ongoing financial issues and massive liquidation by municipal bond funds have caused yields to rise sharply. Fund-related selling pressures have eased, but the possibility of increased issuance and ongoing concerns over municipal finances could exert further upward pressure on yields through the year. We continue to monitor the state of municipal finances very closely, but despite the ongoing issues RBC Wealth Management continues to recommend municipal bonds to investors, specifically higher quality general obligation, essential purpose revenue, select education, and hospital/healthcare issues. In our opinion, these higher yields will present investors with the most attractive opportunities for a number of years.

For illustrative purposes, the following chart shows the comparative yield curves for municipal bonds and U.S. treasuries as of February 3, 2011.

### U.S. Treasury vs. AA+ Municipals General Obligation Curve



Source: Bloomberg L.P.

\*Assumes 35% income tax rate

*Key take away — Tax-free municipal bonds remain attractive to high income earners as investment options despite financial issues facing municipalities. The expiration of the Build America Bond program will likely result in increased issuance of traditional tax-free bonds in 2011, which could exert upward pressure on yields. In our opinion this will present investors with attractive investment opportunities.*

## What Are the Dividend Income Implications?

As a result of the Tax Relief Act of 2010, increased tax rates post 2012 on dividend income could result in price volatility with dividend-paying common stocks and qualified dividend income preferred stocks. But the volatility is hard to predict as it is unclear what the dividend tax rate will be.

It is important to note that the historical average tax rate on dividend income is 40% — a level that has not over time discouraged investors from owning dividend-paying stocks.

*Key take away — Dividend tax rates could increase in 2013, but selling dividend-paying stocks as a result would be a clear case of allowing tax concerns to drive sound investment policy.*

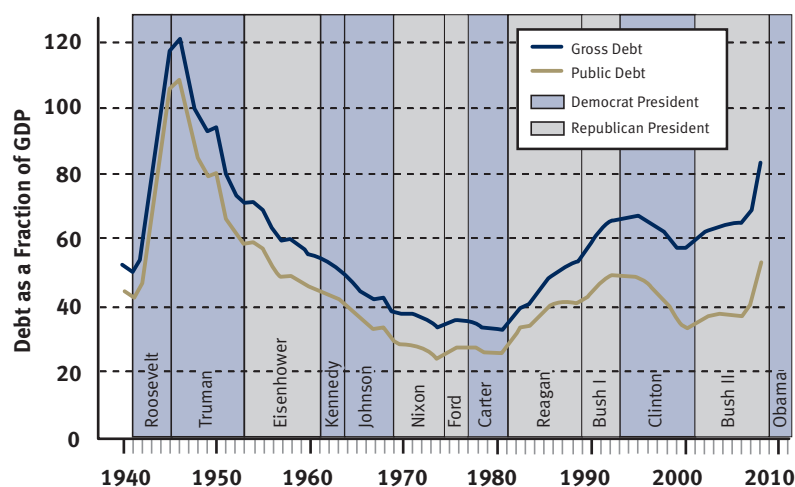
## What Are the Overall Economic Implications?

According to The World Factbook published by the U.S. Central Intelligence Agency, the public debt (defined as the cumulative total of all government borrowings less repayments denominated in U.S. dollars) was estimated to be approximately 59% of the gross domestic product (GDP) in 2010.<sup>3</sup>

A large part of this debt can be attributed to the deficit spending on programs many experts agree may have helped keep the recession of 2008-2009 from lasting longer or plunging deeper. Many experts also anticipate the federal deficit to continue growing as government spending increases. So some historical perspective may help show what our national debt to gross domestic product ratio really means.

From 1946 to 1953 — following World War II and deficit spending that helped pull our economy out of the Great Depression — the public debt ranged from 58% to 108% of gross domestic product. Or almost \$10 trillion in today's dollars, at its peak. Compare the years following the recessions of the early 1980s and the market crash of 1987. From a public debt low of 25% of gross domestic product in 1981, the public debt grew to 49% of gross domestic product in 1993.<sup>4</sup>

GDP vs. Debt by Administration



Source: www.WhiteHouse.gov

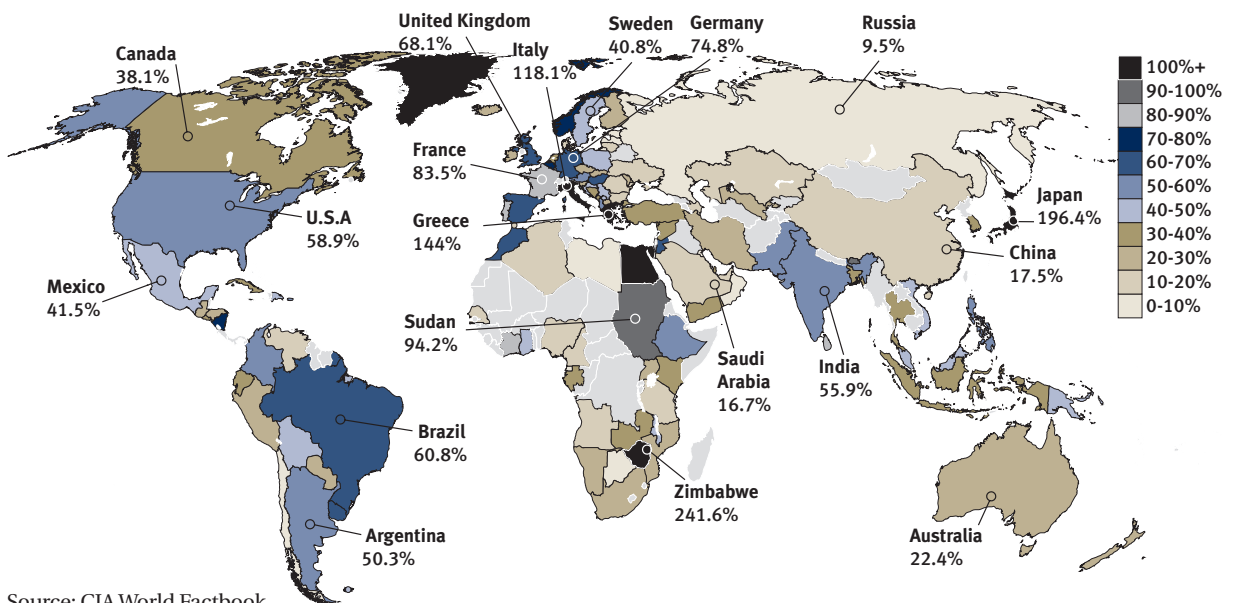
| Maximum Tax Rate on Ordinary Income |                       |
|-------------------------------------|-----------------------|
| Tax Year                            | Top Marginal Tax Rate |
| 1946-1947                           | 86.45%                |
| 1948-1949                           | 82.13%                |
| 1950-1951                           | 91.00%                |
| 1952-1953                           | 92.00%                |
| 1954 to 1963                        | 91.00%                |
| 1964 to 1967                        | 70.00% to 77.00%      |
| 1968                                | 75.25%                |
| 1969                                | 77.00%                |
| 1970                                | 71.75%                |
| 1971 to 1981                        | 70.00%                |
| 1982 to 1986                        | 50.00%                |
| 1987                                | 38.50%                |
| 1988 to 1990                        | 28.00%                |
| 1991 to 1992                        | 31.00%                |
| 1993 to 2000                        | 39.60%                |
| 2001                                | 39.10%                |
| 2002                                | 38.60%                |
| 2003 to 2012                        | 35.00%                |

Source: Congressional Research Report to Congress, 2003

Based on economic conditions and federal spending, tax policy has varied widely over time, as well.

It may also be helpful to look at the U.S. public debt to gross domestic product ratio, relative to other countries. In 2010, the U.S. had the largest economy in the world and the 36th highest public debt to gross domestic product ratio. Other leading world economies with higher ratios included: Japan at 2nd (estimate 196%), Greece at 5th (estimate 144%), Italy at 8th (estimate 118%), France at 14th (estimate 83%), Germany at 22nd (estimate 74.8%) and India at 42nd (estimate 55.9%).<sup>5</sup>

### 2010 Public Debt as a Percentage of GDP



Source: CIA World Factbook

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No one wants to pay higher taxes. Yet the prospect has historical precedent, and compared to global peers, the tax burden to service national debt tends to be lower for Americans. Looking to the future, to balance the budget, revenue must increase, spending must decrease or a combination of both. Historically, the U.S. government has not succeeded at making long-lasting spending cuts. This means the revenue component of balancing the budget becomes more critical. Raising taxes is not the only solution, though.

Another possible solution being considered is the idea of a value-added tax on consumption. This form of consumption tax differs from a national sales tax in that it is paid by all the producers in the supply chain of a good or service purchased by a consumer. The same net effect occurs, however, with consumers paying more at the cash register for goods and services.

*Key take away — Although projected tax increases associated with the record national debt is a concern, these increases are not cause to panic. Deficit spending at this time may aid the economic recovery while maintaining our government's ability to deliver services. Raising taxes alone may not generate sufficient revenue to pay down this deficit. That is why some believe the federal government may consider future tax increases.*

## In Conclusion

High income people will likely see their tax liabilities increase; although, the amount of the increase is uncertain at this time, pending either new legislation or a lack of agreement between Congress and the Obama Administration. While tax increases may be a concern to affected taxpayers, given historical perspective, at RBC Wealth Management we believe the evolving environment is not a reason to make rash investment decisions.

This report is intended for educational purposes only, based on information available at the time of publication. Policymakers may take action at any time, and RBC Wealth Management will continue to keep you informed if legislation occurs. You may consider using the steps provided on page 10 with your RBC Wealth Management Financial Advisor, tax professional and estate attorney to review your wealth management plan.

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## Steps You Can Take Today

Investors who are concerned about future tax uncertainty may want to bring this checklist to meetings with their RBC Wealth Management Financial Advisor, tax professional and estate attorney.

- 1)  Explore tax-advantaged opportunities like converting Traditional IRAs to Roth IRAs. Business owners who experienced a net operating loss may be able to convert tax-deferred retirement assets to a Roth IRA tax free.
- 2)  Take advantage of the lower capital gains rates in 2011 and 2012 before capital gains tax rates potentially rise.
- 3)  Consider accelerating ordinary income from stock options and deferred compensation, if possible, in 2011 or 2012 when you may be in a lower tax rate than future years.
- 4)  Look into deferring tax-deductible expenditures, such as charitable contributions, until years when the individual tax rate may be higher.
- 5)  Check your exposure to Alternative Minimum Tax. Work with your tax professional to identify tax opportunities unique to your situation.
- 6)  Review your portfolio for potential credit issues, adequate maturity diversification, and to make sure it is structured not just to meet current needs, but also with an eye to future ordinary income tax changes.
- 7)  Wait until 2012, when the future qualified dividend tax rate may be better understood, to limit potential portfolio volatility by lightening positions in dividend-paying stocks.
- 8)  Remain watchful for any potential tax changes in the state and/or municipality where you live, because they could raise taxes to make up for lack of federal funding.
- 9)  Review your current estate documents, the way your assets are titled and your beneficiary designations with your attorney and/or tax professional sooner rather than later. If appropriate, revise them to provide planning flexibility in light of the fact the Tax Relief Act of 2010 expires at the end of 2012. Consider use of disclaimer or “what if” language.
- 10)  Take advantage of the gift tax exemption of \$5 million to leverage wealth transfer to future generations.
- 11)  Explore life insurance strategies to transfer wealth to heirs tax free.
- 12)  Discuss whether strategies using life insurance to create tax-free retirement income are appropriate for your goals and time horizon.

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## Seek Professional Tax Advice

RBC Wealth Management is the nation's sixth largest full-service investment, advisory and wealth management firm. While it is a global leader in diversified financial services, RBC Wealth Management does not provide tax advice or tax preparation. For best results, discuss the evolving tax environment with your professional advisors. Your RBC Wealth Management Financial Advisor can collaborate with your professional tax advisor and your estate attorney to help review your wealth management plan, including your estate plan documents.



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<sup>1</sup> U.S. Treasury, Bureau of the Public Debt, Treasury Direct (January 16, 2011)

<sup>2</sup> *Prescription for Change 'Filled' Tax Provisions in the Patient Protection and Affordable Care Act*. Deloitte, March 23, 2010.

<sup>3</sup> Central Intelligence Agency World Factbook

<sup>4</sup> White House Data on Gross National Debt

<sup>5</sup> Central Intelligence Agency World Factbook

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