

## DAVE'S COMMENTARY

# Phantom Tax Investors Should Be Aware Of

To deal with our enormous and rapidly growing national debt in a slow economic environment, our Federal Government is resorting to a technique which has important implications for investors, or anyone concerned with maintaining the purchasing power of their wealth. This technique — called financial repression — and its implications for investors are explained below.

Financial repression is a method that governments may use to reduce their debt burden in real terms relative to Gross Domestic Product (GDP). It is done by keeping interest rates on government debt below the inflation rate, enabling the debt to be repaid with currency that, in real terms, is worth less than the original borrowed amount. In effect, financial repression enables governments to reduce their debt burden in real terms without having to do unpopular things like raise taxes and/or cut spending which may weaken an already fragile economy.

### Wikipedia elaborates on financial repression this way:

*Financial repression is most successful in liquidating debts when accompanied by a steady dose of inflation, and it can be considered a form of taxation, or alternatively a form of debasement. "Unlike income, consumption, or sales taxes, the "repression" tax rate (or rates) are determined by financial regulations and inflation performance that are opaque to the highly politicized realm of fiscal measures. Given that deficit reduction usually involves highly unpopular expenditure reductions and (or) tax increases...the relatively 'stealthier'*

*financial repression tax may be a more politically palatable alternative to authorities faced with the need to reduce outstanding debts."*

The US Federal Reserve Bank plays a central role in executing a policy of financial repression by intervening in financial markets to force market interest rates on government debt below the inflation rate. This is done by buying trillions of dollars of government bonds through efforts like "Quantitative Easing". The Fed controls short-term interest rates and has stated that it expects to keep these rates near zero until late 2014 to help the weak economy recover from the 2008 financial collapse.

Unfortunately such financial repression can have negative impacts on investors and others who want to retain and/or build their purchasing power (i.e., wealth) over time. Earning a lower after-tax return on wealth than the rate of inflation erodes purchasing power of that wealth as time passes. This is why financial repression is sometimes referred to as a "stealth tax". Through financial market manipulation, the government is essentially extracting wealth

from its citizens for debt repayment without having to explicitly raise income, sales, estate or other unpopular taxes.

Since the US and global economies are stuck in low gear or worse, depending on the country, we expect the Fed may maintain their policy of financial repression for several years. Also, because financial repression works best for a debtor government "when accompanied by a steady dose of inflation", we expect our political leaders may support inflationary policies to help reduce our massive Federal debt burden. Therefore, to maintain purchasing power in an era of financial repression, we are recommending multiple strategies for recalibrating investment portfolios.

How you position your portfolio may determine how well you're able to minimize the phantom tax resulting from financial repression. Please contact us if you'd like to discuss ways to protect the purchasing power of your wealth in the current low-rate environment.

*David Bromelkamp*  
President and CEO

The Treasury market is on a collision course with financial repression and it is time to adjust your rudder to starboard to get home safely.

William H. Gross, Managing Director, PIMCO: *The Caine Mutiny (Part 2)*

## Headlines

- We were pleased to welcome three new clients to Allodium during the third quarter and appreciate their trust and business.
- In July Allodium was ranked 405th nationally in Financial Advisor magazine's 2012 Top RIA Survey of the largest independent Registered Investment Advisors in the country in terms of total managed assets.
- On Thursday, August 23rd Allodium hosted an event and tour of the Rembrandt Exhibit at the Minneapolis Institute of Arts as a thank you to our clients and their guests. Our thanks to the many folks who were able to join us for a great evening!
- Our office will be closed on these upcoming company holidays:
  - Thursday, November 22 & Friday, November 23 - Thanksgiving Holiday
  - Tuesday, December 25 - Christmas Holiday

## Upcoming Events

As a client and community service, we welcome opportunities to share investment and fiduciary best practices with individuals, families and organizations. To this end, Allodium will host the following upcoming event:

**DECEMBER 5:** Educational workshop for non-profit leaders on the topic of How to Select Investment Managers.

**Please contact Rachel Halverson at 612-230-3706 or rhalverson@aicria.com to be added to our invitation list for future events and workshops.**

## FINANCIAL PLANNING TIPS

### Tax Implications of the Health Care Ruling

The Supreme Court's recent decision to uphold the health care reform law now virtually assures that new taxes will take effect on schedule in 2013. According to the government, half the cost of the new health reform law is expected to be recouped through two new taxes:

- A 0.9% increase in Medicare tax on annual **earned** income over \$250,000 for married taxpayers and \$200,000 for individuals.
- An additional 3.8% tax on taxable **investment** income received by taxpayers with adjusted gross income over \$250,000 for married filers and \$200,000 for individuals. This extends the Medicare tax to **investment** income for the first time. Previously, Medicare taxes have only been imposed on **earned** income.

#### EXAMPLE:

Assume a married couple has total adjusted gross income of \$300,000 consisting of \$200,000 of **earned** income and \$100,000 of dividend (i.e., **investment**) income. Since this exceeds the \$250,000 threshold by \$50,000, the 3.8% tax would apply to \$50,000 of the dividend income.

This additional tax applies to investment income such as dividends, interest, capital gains, rents, royalties and distributions from annuity contracts. Therefore, a planning opportunity exists for investors related to income that is not taxable such as tax-exempt municipal bond interest and life insurance proceeds. Amounts withdrawn from pensions or IRAs are also not subject to the tax; although they may increase a taxpayer's adjusted gross income.

While there is still much uncertainty surrounding next year's tax rates due to the political debate underway about whether to extend some or all of the Bush era tax cuts beyond their year-end expiration date, it seems rather certain that taxes for those with incomes exceeding \$250,000 will be going up next year. Absent some deal between President Obama and Congress, the wallets of America's wealthiest may feel a little lighter next year.

## We Appreciate Your Introductions

We launched Allodium to provide objective investment advice and personal service to a limited number of individuals, families and organizations. We embrace our responsibility to always act in our clients' best interests. To maximize our objectivity and avoid conflicts of interest, we are a fee-only registered investment advisor that is completely independent from banks, brokerage firms and other financial product providers, and we do not receive commissions for the investment options that we recommend. If you know someone who may be looking this type of objective investment advice, please contact Dave Bromelkamp at 612-230-3702 or dbromelkamp@aicria.com to arrange a friendly, no-obligation introduction.

*Steward* is published quarterly by Allodium Investment Consultants. Please contact Rachel Halverson at 612-230-3706 or rhalverson@aicria.com if you have any comments about this publication or would like to be added to or removed from our mailing list.



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