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Family Office Monthly

The Obama Effect: How the Wealthy are Preparing for the Next Four Years

Welcome to the sixth edition of Family Office Monthly, a concise newsletter covering the evolution of the family office industry and investment needs of the ultra-wealthy.

Edition Preview: In this newsletter we will be taking a more topical focus:

- A look at how the ultra-wealthy and family offices are preparing for President Obama's second term.

After a long election that was expected to shake Washington from its gridlocked slumber, Americans are left with ostensibly the same political reality that existed before the election: Republicans control the House of Representatives, Democrats control the Senate and Mr. Obama won another four years as president. Still, President Obama appears ready to take on some of the big issues that the campaign focused on, namely: debt and deficit.

This is an alarming prospect for wealthy Americans, who have been on the defensive ever since Occupy Wall Street all the way to the President and Democrats' frequent pledges to raise taxes on the wealthy—likely at least by letting the George W. Bush-era tax cuts to expire for those in upper-income tax brackets. Now that the President has won a second term, he appears to be looking to a quick fix to the so-called "fiscal cliff" and he has been adamant that his approach will be balanced, meaning a mixture of spending cuts and revenue increases. It is foolish to predict what exactly Washington will end up with as a solution, but it seems safe to assume that the wealthy will be forced to contribute more—whether that's through tax increases, closing loopholes, eliminating deductions or other measures—and the wealthy, with help from family offices, have long been preparing for this scenario.

Beating the Deadline: With uncertainty surrounding government policies and how they might affect affluent Americans, many high net worth (HNW) individuals are hurrying to push through financial transactions under the current tax and regulatory environment. The fear is that Congress and the White House will enact a less favorable tax environment that will cut into expected returns on investments and total wealth. To combat this, HNW individuals and their family offices are racing to beat the deadline before a presumably worse business and tax climate emerges next year. Ben Grosz, an attorney at Ivins, Phillips & Barker, Chtd. in Washington, DC who advises HNW individuals, has noticed a sense of urgency before 2013 among his firm's clients, "With expiring provisions related to income and capital gains taxes, gift and estate taxes, and the generation skipping transfer tax, many consider these last 52 days to be an historic opportunity."

Carried Interest and Capital Gains: For those in the financial industry, one of the most contentious issues has been the taxing of carried interest. Professionals at hedge funds, private equity funds and other funds are largely compensated through carried interest (the percentage of performance gains that the fund charges investors) which is taxed as capital gains and not the significantly higher tax rate that applies to ordinary income. President Obama has already proposed several budgets that suggested changing the tax treatment of carried interest to be taxed as services income.

More broadly, if the President and his Democratic colleagues in Congress succeed in raising taxes on the wealthy, one likely source of revenue would come from increased capital gains taxes. Democrats have long argued that capital gains, which are taxed at a much lower rate than ordinary income due to the risk involved in investing, unfairly favor the wealthy. Many readers will recall that the day after the election, the stock market took a dive; Wharton finance professor Jeremy Siegel explained the event as a direct result of investors fearing that capital gains would be taxed more heavily in Obama's second term, sparking a sell-off. Professor Siegel told CNBC, "I think a lot of people with capital gains have been locked in saying 'I'm going to take them under 15 percent instead of 23.8 percent.'"[1] If the markets are correct and capital gains are taxed higher, the effect on family offices and their clients will be dramatic and—as shown by the recent selloff—immediate.

Taxes, Taxes, Taxes: Perhaps most disconcerting to high net worth individuals is the prospect of increasing income taxes over the next four years. With the Bush-era tax cuts set to expire at the end of this year, President Obama is pushing hard to renew only the Middle Class tax cuts, allowing the tax breaks on higher income taxpayers to reset to higher rates. After resisting any legislation that included increasing revenue, Republicans now appear ready to include some form of revenue which would suggest that high income individuals will end up paying more in some ways. Michael Schroeder, CEO of Wasmer, Schroeder & Company—an RIA whose clients include HNW individuals and family offices— explains the situation, "whether in the form of higher tax rates or by means of limiting deductions, those with high incomes are very likely looking at paying more federal and, in some states like California and Minnesota, state income taxes after January 1st, 2013." As wealthy individuals and families look toward the future it increasingly becomes not a question of whether they will have to pay more next year, it is now only a question of how much.

To discuss the ideas in this edition or any other challenges you are facing, call me at (503) 922-1811.

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About Richard C. Wilson & the Family Offices Group

Richard C. Wilson works with family offices and ultra-wealthy families daily, and is author of "The Family Office Book: Investing Capital for the Ultra-Affluent."

[1] Menza, Justin. "Capital Gains Tax Fears Behind Stock Selloff: Siegel." CNBC. Wed. 19 Nov. 2012.