CALIFORNIA QUICK MARKET UPDATE

How will Proposition 30 Impact Californians?

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Expiration of the Bush-era tax cuts has been a contentious topic of discussion for the last three years. In preparation for the potential changes, many investors have implemented complex and sophisticated wealth transfer techniques to help reduce the impact of estate taxes when they pass along large sums of money. In essence "squeezes", "freezes", "IDGTs (Intentionally Defective Grantor Trusts)" and "GRATs (Grantor Retained Annuity Trusts)" have become familiar expressions in the wealth planning arena. Nevertheless, some wealthy investors may have missed a potentially once-in-a-lifetime tax savings opportunity altogether either because they have been unconcerned about additional taxes or have been unwilling to relinquish control of their assets. Other investors may have dismissed the wealth planning opportunity because they presumed that the tax changes would only affect the ultra-wealthy segment. We have now reached a point where it has become clear that gift and estate tax increases may not be the only tax changes on the horizon, but also Californians can expect even higher tax rates than the country in general.

Following the U.S. presidential election, some Californians awoke to the reality that Proposition 30 (Prop 30) had passed asking themselves—what do you mean I have to pay higher taxes on my income temporarily and retroactively? Our observations suggest that the vernacular surrounding the topic has changed to *deferring, shifting, mitigating, postponing and avoidin*g—not the *taxes* but the *conversation*! Over the past four decades California's personal income tax has been a significant source of revenue for the state, making it an essential and critical component of California's fiscal health. If the U.S. Congress takes no action and the Bush tax cuts expire, this along with Patient Protection and Affordable Care Act (PPACA) and Prop 30 will affect a majority of California tax payers given the increases outlined in Table 1 on page 2.

The key provisions of Prop 30 include:

- Increases of statewide sales and use tax by ¼ cent for four years from 2013 through 2016.
- Increases in the marginal rate of personal income tax on annual earnings over $250,000 for individual filers of:
  - 1 percent up to $300,000 in earnings
  - 2 percent on earnings between $300,000 and $500,000
  - 3 percent on earnings above $500,000
- Increases in the marginal rate of personal income tax on annual earnings over $500,000 for joint filers of:
  - 1 percent up to $600,000 in earnings
  - 2 percent on earnings between $600,000 and $1,000,000
  - 3 percent on earnings above $1,000,000

- For households where the head of household is a high earner, the thresholds are lower
- The income tax increases will be in place for seven years starting from the 2012 tax year through 2018.
- The top California marginal tax rate for 2012 is now 13.3 percent for taxpayers exceeding $1 million in California-state taxable income. This rate includes the current 1.0 percent Mental Health Tax. That's a 30 percent increase over last year's tax rates!

TABLE 1: Proposition 30 and Expiration of Bush Tax Cuts Potential Impact

	Federal		State - California
Everyone	_10%-35% increase to 15%-39.6% _Long Term Capital Gains 15%-20% _Dividends 15% to ordinary income rates, as high as 39.6% _Child care deduction limit from $3,000 to $2,400 _Student loan interest deduction ceases _Reduced earned income tax credit _American College Opportunity credit expires _Refundable adoption credit ceases and deduction decreases	_Education IRA Limit drops $3000 to $500 _Social Security Tax w ithholding rates increases from 4.2% to 6.2% _Increases floor for medical deductions from 7.5% to 10% _Deduction for Medicare Part D expenses eliminated _Flexible Spending arrangements limited _Estate taxes from 35% to 41%-55% _GST Exemption decreases from 5.12M to 1	Sales and Use Tax increased by 1/4 cent for Prop 30
Single w ith $200,000+	0.9% income tax increase for Medicare 3.8% tax on net investment income		
Single w ith $250,000+	0.9% income tax increase for Medicare 3.8% tax on net investment income		A 1% to 3.0% increase in state income tax for Prop 30 depending on income level
Married filing jointly w ith $250,000+	0.9% income tax increase for Medicare 3.8% tax on net investment income		
Married filing jointly w ith $500,000+	0.9% income tax increase for Medicare 3.8% tax on net investment income		A 1% to 3.0% increase in state income tax for Prop 30 depending on income level

Source: California Planning Team

Please note: Net investment income includes taxable interest, dividends, annuity payments, passive royalties, rent, etc. but not municipal bond interest, Roth IRA and Traditional IRA distributions, nor payments from qualified retirement plans.

Prudent and proactive tax planning, now more than ever, will become necessary not only for wealthy investors but also average investors. Moreover, sales tax increases will affect most Californian residents. According to IRS projections for 2011, a family of three will experience the following tax increases after the percentage increase is applied:

Table 2: Estimated Impact of Sales Tax Increase

Annual Income	Additional Yearly Tax	Cost Per Day
$20,000 to $30,000	$20	5.4 Cents
$50,000 to $60,000	$30	8.3 Cents
$100,000 to $120,000	$44	12.1 Cents
$200,000 plus	$73	21.1 Cents

Source: IRS, 11/19/12

Coordination of federal and state taxes could become a subtly choreographed tango of sorts (or perhaps more aptly rendered "tangle") that may necessitate the assistance of financial and tax professionals. Take, for example, the exercise of calculating state income taxes. State income taxes are generally deductible from federal income taxes, so the impact of higher state income taxes could potentially be offset by lower federal income taxes. This means that $1,000 in additional California personal income tax computed at a federal rate of 35 percent could reduce the federal income tax burden up to $350. However, as of the date of this publication, no Alternative Minimum Tax (AMT) "patch" has been enacted and the Internal Revenue estimates this will affect the filing status of an additional 28 million taxpayers—significantly higher than in 2011 at an estimated 4 million. With the labyrinth of potential tax changes following the adoption of Prop 30, investors will likely need the guidance of knowledgeable tax and financial professionals and "plan to plan" the timing of income generation and applicable taxation.

Practical tax planning ideas for consideration in a higher-tax environment:

- *Roth IRAs* - Investors who can afford to pay the additional taxes required are choosing to convert their traditional Individual Retirement Accounts (IRAs) to Roth IRAs in a double-whammy attempt to capture tax-free growth as well as recognize income at the lower 2012 tax rates, rather than the increased ordinary income tax rates that could go into effect in 2013 should the Bush tax cuts be allowed to expire. Not to mention the additional Medicare taxes that could arise.
- *Equity compensation planning* - Those investors with unexercised options or restricted stock awards have also climbed aboard the tax train by choosing to exercise their options or make 83(b) elections this year under the same notion that tax rates could increase next year. The potential tax savings exist even with the retroactivity of Prop 30 rates and "in the money" transactions.
- *Donor Advised Funds front loading* – Those investors who are philanthropically inclined and expect their tax rate to increase, should ask their investment professional about how front loading their donor-advised funds in higher income and tax years might help to alleviate the extra tax burden given how valuable deductions likely will be in future years.
- *Leveraging insurance* - Higher tax rates send nearly everyone in search of tax-efficient investments. While most investors don't consider insurance as an investment, a properly structured insurance strategy may provide a benefit that can be received on an income tax

and estate-tax-free basis and could provide an investment return that you may not have anticipated at the purchase of the policy.

- *Income shifting* – Gifting long-term capital gain investments or income producing property to family members who are not subject to higher federal and state tax, "kiddie" tax or the 3.8 percent surtax can provide savings for the family enterprise all around.

In addition to positioning their investments in appropriate structures, investors should consider asset classes that have the potential to generate sufficient income in a tax-efficient manner to accomplish short-term obligations. At the same time, investors need to make sure that assets are poised for long-term growth in this uncertain environment. The "yes" vote on Prop 30 combined with potentially higher federal tax rates has a number of important investment implications. As always it's important to not let the tax tail wag the dog. Investment decisions should always come first, followed by effective tax management.

Investment Implications of Proposition 30

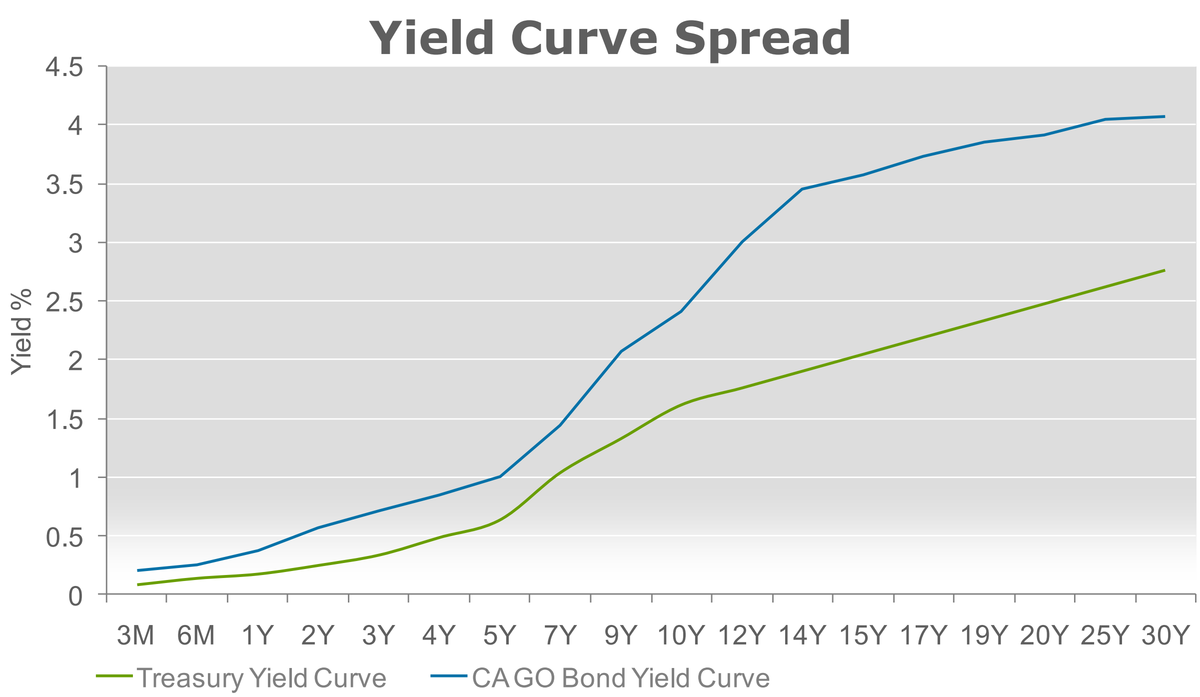
Many investors have been worried about the credit quality of California's general obligation bonds. Standard & Poor's (S&P) currently rates California debt at A-, the lowest rating for all 50 states. In addition, a few municipalities including the cities of Stockton and San Bernardino filed for bankruptcy earlier this year, leaving some investors concerned that the state's budgetary shortfalls could impact the principal and interest payments on their holdings of California state municipal bonds.

While Prop 30 may not be popular with some tax payers, many investors are likely pleased that it passed. In one fell swoop, voters, by an eight percent margin, have helped to shore up California's state finances. According to the California Department of Finance, Prop 30 is projected to raise the state's baseline revenues by more than $6 billion annually through fiscal 2017 and by a smaller dollar amount for the two subsequent fiscal years. The measure also prevents the triggering of nearly $6 billion of mid-year cuts that otherwise would have significantly impacted the K-12 education sector beginning in January. Prop 30 also contains key spending provisions by upholding the state's realignment initiative which is expected to generate additional savings for the general fund. While the tax increases under Prop 30 are temporary, we view its passage as a positive step in reducing the state's protracted structural budget imbalance.

California voters also awarded Democrats a two-third supermajority in each house of the state legislature. This supermajority status provides California Democrats the ability to pass a budget without any input from their Republican counterparts. No single political party has held this level of a majority in California since 1933. While concerning to some constituents, this supermajority should reduce the number of near-term budget impasses and political gridlock—such as the situation we experienced in the fall of 2010. These political dynamics stand in stark contrast to the fiscal cliff challenges at the federal level. Overall, we view the passage of Proposition 30 as a positive development from an investor's standpoint. By providing a temporary but significant increase in tax revenues and reducing the state's general fund spending through realignment, we believe Prop30 will help reduce the state's chronic fiscal challenges.

Investors in the highest tax brackets should now find California municipal bonds even more attractive. One key point for investors to recognize is the double tax-free nature of California bonds—investors pay neither federal nor state taxes on the interest received. Consider an investor in the highest income tax brackets both federally and in California. If the Bush-era tax cuts expire, income tax rates will rise to 39.6 percent. In California, the highest state income tax rate rises to 13.3 percent from 10.3 percent.

The chart below shows how attractive California municipal bond yields are relative to U.S. Treasury bonds. The blue line represents California general obligation bonds and the green line, U.S. Treasurys. At every maturity, California municipal bonds offer higher yields than U.S. Treasurys, underscoring why we remain underweight U.S. Treasurys. When you consider the corrosive effect of taxes on many types of investments, municipal bonds potentially offer considerably more attractive returns.



Source: Bloomberg, 11/19/12. Past performance is no guarantee of future results.

Additional Investment Strategies to Consider

California investors face a brand new landscape of higher state and federal taxes. We believe that prudent coordination of tax planning and investment planning are even more essential in this new environment. With that thought in mind, we continue to recommend high-quality municipal bonds for those investors in the highest tax brackets. The exact mix of bonds is unique to each individual's financial situation. We also recommend adding other fixed-income vehicles such as high-yield bonds and emerging market debt to provide supplemental income streams for portfolios. With the increased tax rates in California and the potential for higher federal tax rates, many investors may consider switching from high-yield taxable bonds to high-yield tax-free bonds in taxable accounts. These bonds typically offer higher after-tax yields and provide a better hedge against inflation.

In addition, we recommend a diversified income stream approach to capture yield across multiple asset classes, as a strategy to help offset higher tax rates. We believe adding multiple sources of income to a portfolio may be even more essential today for California investors. For example, many global equities presently offer dividend yields of two to three percent. These yields are attractive compared to those of U.S. Treasurys. In fact, dividends tend to increase at a rate that exceeds inflation over longer time frames. In addition, a number of studies have found that dividend-paying stocks can perform well even in higher tax environments. For example, the Center for Research in Security Prices (CRSP) studied stock prices from 1926-2011 under different tax regimes. Stocks performed well even in an environment with much higher tax rates.

Likewise, real estate investment trusts (REITs) tend to have more attractive yields than many fixed income investments. Furthermore, REITs are not subject to some of the higher tax rates that may apply if the Bush-era tax cuts expire, such as the higher tax rate on qualified dividends. A similar analysis would apply to potential opportunities in Master Limited Partnerships (MLPs) that focus on investments in oil & natural gas storage and pipelines.

Finally, opportunities in the complementary strategies asset group may provide higher income streams at the expense of portfolio liquidity. However, vehicles in this asset group typically require special investor qualifications and may carry additional constraints or risks. We encourage you to speak with your investment professional to determine whether these types of investments are appropriate for your asset allocation strategy. In working with your investment professional, we also recommend discussing the planning and investment strategies outlined in this update with your tax advisor and wealth planner to determine a course of action that is suitable for your specific circumstances

Data for this QMU sourced from Bloomberg unless otherwise noted.

Disclosures

Fixed income securities are subject to availability and market fluctuation. These securities may be worth less than the original cost upon redemption. Certain high-yield/high-risk bonds carry particular market risks and may experience greater volatility in market value than investment-grade corporate bonds. Government bonds and Treasury bills are guaranteed by the U.S. government and, if held to maturity, offer a fixed rate of return and fixed principal value. Interest from certain municipal bonds may be subject to state and/or local taxes and in some instances, the alternative minimum tax.

Municipal bonds offer interest payments exempt from federal taxes, and potentially state and local income taxes. Unlike U.S. Treasuries, municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer.

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