

If you are having trouble reading this email, [read the online version](#).  
Please do not reply to this email



March 4, 2010

### **Flagship Flap**

In our last update, we mentioned that Vanguard Brokerage had responded to Fidelity and iShares' offer of commission-free trades on 25 iShares ETFs by increasing the number of free trades Flagship investors could make in 2010 from 12 to 100. Since then, there's been a lot of confusion and frustration among Flagship clients, as many have been told that the 100 free trades are only for those with \$10 million or more with Vanguard, while others with substantially less than that amount have been offered the free trades.

While we still don't have the full story, Vanguard apparently has a set of criteria (which the firm is refusing to reveal) to determine which Flagship investors are given the 100 free trades and which are limited to 12. Having \$10 million with Vanguard will get you the 100 freebies, but it is definitely not the sole criterion. If you are a Flagship client and feel you should be getting the 100 free trades, our best advice is to give your representative a call and tell them you want to know what you need to do to qualify, if you've been excluded.

### **The AMT Could Send You to the ATM**

As tax time rolls around this year, there's a three-letter acronym besides IRS that once again will give taxpayers and accountants fits. It's the AMT, or Alternative Minimum Tax. Congress created the AMT in 1969 after discovering that 155 taxpayers making over \$200,000 (a princely sum in those days) had avoided paying any federal income tax. Unfortunately, the AMT was not indexed to inflation and over the years it has begun to affect more and more people. For tax year 2009, about 4 million taxpayers will have to pay up under AMT rules, and they could owe thousands of dollars more on their return as a result.

Essentially, the AMT functions in a parallel universe to the normal income tax, with different rates and methods of calculating income and deductions. If you fall into a certain income range, you have to calculate both your normal income taxes *and* the AMT and then pay whichever is higher. Many more than the aforementioned 4 million people who will be subject to paying the AMT will have to take hours filling out the necessary worksheet and form to figure out whether

### **In This Issue**

- **Flagship Flap**
- **The AMT Could Send You to the ATM**
- **Vanguard Sector Shift**

they owe it or just the normal income tax.

Possibly the most frustrating aspect is that many people who go to the trouble of filling out the AMT form will find that, in the end they don't owe the tax. But since the number of people subject to the AMT has begun to rise, the IRS has been keeping a sharper eye out for AMT-related mistakes, so it behooves you to do it, or to hire a professional to help you out if you're unsure about your return.

You can expect to be subject to the AMT (or at least to filling out the form) for tax year 2009 if your taxable income exceeds the exemption, which is currently \$70,950 for married couples and \$46,700 for singles and heads of households (for tax year 2009, married couples are five times more likely to be subject to the AMT than singles—if there is no solution for 2010, this will balloon up to 14 times more likely). As the law now stands, these amounts will drop considerably for tax year 2010 (there is a provision already in place for 2009), which would cause the number of taxpayers hit by the AMT to jump to that estimated 27 million households if no further patches are applied.

The people who should be most concerned about the AMT are those with children; especially two or more. According to the Urban-Brookings Tax Policy Center of Washington, D.C., for tax year 2010, 38% of married couples with two children and 42% of married couples with three or more children will have to pay the AMT. And for those with higher levels of income, 92% of households with income between \$200,000 and \$500,000 and 75% of households with \$100,000 to \$200,000 in income will have to pay for tax year 2010.

In the past, part of the reason that Congress and the President have been unwilling or unable to eliminate the AMT is the cost. It is estimated that getting rid of this tax would cost an estimated \$850 billion in tax revenue over the next decade. Just applying an annual patch for tax year 2009 to keep the number of people affected by the AMT at around 4 million is projected to cost well over \$30 billion. While the changeover to a Democrat-led government has provided some hope about getting rid of the AMT, it is unlikely any real change will occur until the Bush tax cuts are allowed to expire (due to happen after tax year 2010), which would make up for the cost of eliminating the AMT altogether. This may be the year we see some sort of final (or at least less temporary) solution to the AMT, as President Obama's proposed 2011 budget includes a provision to permanently index the tax to inflation, which should certainly cause some lively debate in Congress.

For those of you who exercised incentive stock options (ISOs) and qualified for the AMT as a result, there is a little-known provision that could potentially net a refund. Regular taxes do not factor in the "bargain element" of exercising an ISO; AMT taxes do, meaning that you're taxed on the difference between the fair market value of the ISO shares and the exercise price on the date you exercise the option. This can add up to a substantially larger tax bill. This is where the "AMT credit" comes into play—taxpayers subject to the AMT who exercise ISOs are generally granted a credit that can be carried forward indefinitely and applied to future tax returns to cover amounts

in excess of what you'd pay under the AMT (this typically comes into play when your normal income taxes are marginally higher than the AMT, giving you a small break). If you earn an AMT credit one year and are subject to the AMT the next year, the credit cannot be used. However, there is a very beneficial exception if you have AMT credits that are more than three years old—these old credits become refundable, which means they can be used to reduce taxes and give you the opportunity to collect any leftover amounts in cash. So if you have been hit with big AMT tax bills in the past and think you may have credits, we strongly urge you to look into this provision—it might just put some money back in your pocket.

Fidelity, along with several other mutual fund companies, has taken some steps towards helping investors stave off paying the AMT. The firm currently offers six AMT sensitive municipal money market funds (AMT Tax-Free Money Market, Tax-Free Money Market, California AMT Tax-Free Money Market, Massachusetts AMT Tax-Free Money Market, New Jersey AMT Tax-Free Money Market and New York AMT Tax-Free Money Market), and two AMT sensitive bond funds (California Short-Intermediate Tax-Free Bond and Tax-Free Bond) which seek to invest only in securities whose interest is exempt from the AMT (and normal income taxes as well). While these funds can provide AMT protection when used in a wide-reaching tax strategy, don't expect them to protect you from having to calculate the AMT just because you hold them.

Vanguard has not elected to provide any AMT-free funds as of yet, instead limiting most funds' holdings to a max of 20% of assets in bonds with interest subject to the AMT. The reason, according to Christopher Ryon of Vanguard's Fixed Income Group, is that eliminating AMT-taxable bonds would reduce diversification and lower the yields of certain funds.

This alternate tax system is a problem for taxpayers that will keep growing each year, and regrettably, unless the government takes action, there is no simple solution. We would like to be able to give you some specific advice about how to beat the AMT, but in this case the power for change lies with Congress and the President. Mutual fund families may be able to help out to a small extent by offering more AMT-free funds, but these are not the kinds of funds most investors will flock to, at least for a majority of their assets. Our best suggestion is to consult with a tax specialist if it seems as though you'll have to pay the AMT or if you've paid it in the past and think you might qualify for the credit. While you might not feel great about having to pay it, at least you'll have the peace of mind knowing that your taxes were correctly calculated and that the IRS won't come knocking on your door, looking to crack your nest egg.

### **Vanguard Sector Shift**

Last week, Vanguard announced that it had changed the benchmarks for the 10 sector funds (and ETFs) based on MSCI indexes to a new, more tax-friendly set of MSCI Indexes. While we don't think the changes are going to have a huge effect on performance (or cause us to look more favorably on these narrowly-focused offerings), the move points out a big flaw with sector funds: Diversification (or lack thereof,

as is the case here).

The new benchmarks were developed to better adhere to IRS code for more favorable tax treatment, specifically the "25/50 rule," which specifies that no more than 25% of a fund's assets may be invested in a single stock, and no more than 50% of assets can be invested in individual stocks that represent 5% or more of assets each. In its press release, Vanguard mentioned that the underlying bogeys for the Consumer Staples Index, Energy Index and Telecommunications Services Index funds all have run afoul of this IRS rule at various times. As a result, those funds have had to underweight larger companies in their benchmarks and overweight smaller ones, which has caused significant tracking error between the funds and their benchmarks' performance in the past.

By switching to the new benchmarks (named similarly to the previous bogeys but with "25/50" appended), the funds should be able to more closely track performance and reduce turnover in the portfolios. The changes, however, will do nothing to curb the underlying volatility in most of these sectors and funds, and, for that reason, we'd advise you to continue to steer clear.

### **About Adviser Investments**

Adviser Investments is an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 1,500 clients and \$1.1 billion dollars under management, Adviser is one of the nation's largest mutual fund research and money management firms. Our staff of 35 investment professionals focuses on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is \$350,000.

For more information, please visit [www.adviserinvestments.com](http://www.adviserinvestments.com) or call 800-492-6868.

You are receiving emails from Adviser Investments at the email address of **EmailAddress** because you have agreed to receive updates and information about Adviser Investments via email. To unsubscribe from further email based communications and special offers, please [click here](#) For more information you can also see our [Privacy Policy](#).

Adviser Investments  
85 Wells Avenue  
Newton, MA 02459  
USA

Powered by  ELOGUA