



**The Fortunate 400**  
*Tax hints from the really rich*

We often hear that the ultra-rich somehow manage to keep their taxes relatively low, despite stunning income levels. Is it true? And if so, how do they do it? Data from the tax returns of the 400 largest individual U.S. taxpayers sheds light on this question, and offers some important guidance to the remaining 99.9% of the population as April 15<sup>th</sup> approaches.

Dubbed the “Fortunate 400” by Joel Slemrod of the University of Michigan, the top 400 taxpayers had average annual incomes of \$213 million for the year 2005. Yes, you read that right. Just to make the lowest rung on this exclusive ladder meant reporting income of more than \$100 million.

**Fair share?**

The Fortunate 400 paid, on average, just over 18% of income in taxes in the year covered by the data. While writing a check to the IRS for \$20-60 million is hardly a free ride, 18% is a relatively modest portion of income going to the Treasury.

I will leave it to others to comment on the growing concentration of income, fairness questions, and potential plutocracy that this IRS data imply. I will limit my commentary to investing and taxes, and how investment strategy can have a profoundly positive impact on one’s overall tax rate.

**What’s the secret?**

People of all levels of wealth know very well about strategies for reducing one’s overall tax rate from the highest marginal federal rate of 35% on wages, taxable interest, and short term gains to the lowest legal level. A good accountant can help you take advantage of the various tools available that let you keep more of what you make. And, since the days of tax shelters and special deals are long gone, there are probably really very few tax strategies you can adopt that you haven’t already. Good records and a good accountant can shave down the tax bill.

But the question remains, if the very rich, with incomes over \$200 million per year, are paying an average tax of 18%, how are they doing it? They may have a lot more money, but they are subject to the same laws as everyone else.

A deeper drill into the data reveals the answer.



### **Favored sources of income**

The biggest factor in keeping the Fortunate 400's tax rate down has little to do with fancy tax strategies. It is much more about the sources of their income. Most notably, capital gains accounted for 58% of their income. Partnership and S-corp income was next at 17%. Wages came in at 8% (an average of \$22 million!). Taxable interest and qualified dividend income rounded out the rest, coming in at 7% each, bringing the total close to 100%.

Simple math explains the 18% tax rate. With two thirds of income coming from capital gains and qualified dividends, both taxed at 15%, the F400 are off to an excellent start. The 400ers also gave an average of \$19 million apiece to charity, almost offsetting their wages. Tax the remainder of partnership income, wages, and taxable interest at 35%, and the total rate comes in around 18%.

Here's the key: For this math to work out, the vast majority of capital gains must be long term gains, taxed at 15%, not short term, which are taxed as regular income.

Granted, not everyone has sufficient capital to produce two-thirds of total income from long term gains and dividends. But it is a goal to strive for. By far the most compelling message from the IRS data, in my mind, is: *invest for the long term*. Tax policy handsomely rewards it; Uncle Sam will essentially pay you to invest long-term, by letting you keep more of what you make.

### **How long is long term?**

It depends whom you ask. The IRS says 12 months.

"Forever," says Warren Buffett. And anyone who invested with Buffet decades ago would likely agree.

But Barton Biggs in his latest book, *Wealth, War and Wisdom*, disagrees. Biggs, who was formerly chief global strategist for Morgan Stanley, and now runs the hedge fund firm Traxis Partners, says, "There are no magnificent long-term 'keeper' stocks to put away forever, and there never have been because no company has ever had a sustainable, *forever* competitive advantage."

He's right. Consider the Dow Jones Industrial Average (DJIA), first published in 1896. Of the original 12 company roster, only General Electric is still a part of the index. Others, such as U.S. Leather Company, have been out of business for decades. Likewise, of the 1917 Forbes list of 100 largest companies, by 1987, 61 were no longer in existence. Only 18 of those 39 that remained were large enough to stay on the 1987 Largest 100 list. Of those 18, only 2 managed to outperform the general stock during that 70 year period. Langdon Morris, the calculator of the above facts and author of *Business Model Warfare* concludes, "This trend in corporate mortality is, in other words, a serious issue with significant implications."



### **Own it all**

So, if the goal is to invest for the long term, but great, profitable companies don't last forever, what's the right approach? In such a world, we advocate indexing – buying groups of everything – to capture the long term natural selection process of the markets. [See our 2007 article, [Tax Efficient Portfolio Management: \*Keeping more of what you make\*](#)]

In my view, indexing solves one of the central challenges of investing – trying to predict which stocks will appreciate over time. Over the next 20 years, which stock will rise? Or fall? Or disappear? Apple or Microsoft? Google or IBM? Pfizer or P&G? It's impossible to know. Consider instead buying all of those stocks, and hundreds of other large companies. Buy them in an index that adapts over time, adding growing companies and removing companies that fade, get acquired, or change in other ways that don't fit the index. Go back in time to 1987 and buy the DJIA at 1900 or so. That noise you'll hear for the next 20 years is the happy sound of compound growth.

Own indexes of large companies. And small companies. And European companies. And Asian companies. And commodities. And currencies. And so on. With a diverse set of indexes, an investor can reap the long term benefits of all markets, without ever having to pick an individual security. Nor does one ever have to sell an index, except for rebalancing.

### **Like Barton says**

Quoting Barton Biggs again, “Diversification of wealth in equities over decades or generations means either buying index funds or somehow finding the unusual investment management firm that with wisdom and vision can construct a diversified portfolio that will at least keep up with and hopefully beat the averages – after taxes and fees.” He continues: “If you live in a stable country and you know with a high degree of certainty you can achieve a long-term real return of 400-700 basis points in an index fund why fuss with anything else?” And: “It pains me to write it, but professional investors don't do much better (beat the S&P 500) on a statistically significant, risk-adjusted basis.” Barton's comments neatly summarize the gravitational pull of diversification combined with indexing. And this from a famously successful investor who now runs a large hedge fund.

### **Reality check**

Is your portfolio structured to deliver long term gains? It's really a two-part question:

- First, *can* the portfolio produce long term gains? For example, a portfolio split 60/40 between stocks and bonds means that 60% of your capital could produce long term gains, while 40% generally will not. Bonds provide income, liquidity and, for many, peace of mind. But they typically do not produce long-term gains.



- Secondly, and most importantly, *is the portfolio producing long term gains? Using the example above, how is the 60% equity position invested? Some investment managers pay attention to taxes. Others, especially those that operate mainly for non-tax paying institutions, may employ high-turnover strategies that produce significant short term gains. To find out where your portfolio stands, ask your advisor for your after-tax performance numbers. After all, they are the metrics that matter most for building and protecting wealth. [Note that some active managers, like Eaton Vance, have led the way in producing investment products that are specifically and intentionally tax aware and are therefore suitable for individuals. Unfortunately, EV is the rare exception that proves the rule.]*

Appreciation without recording gains is completely possible with indexing. In fact, tax efficiency is a strength of the indexing structure. As an example, Barclays iShares, the largest indexer, did not make any capital gains distributions on 137 of its 141 funds in 2007. One of its biggest index products, Barclay's \$17b billion S&P 500 index (IVV), has made exactly zero capital gains distributions since its establishment 7 years ago. That is real tax-deferred compounding potential!

**The OCM difference**

Osbon Capital Management considers long term after-tax return the most important measure of portfolio performance. Because we work only with individuals and families, every investment decision is made with personal income tax implications in mind.

**We're all Fortunate**

Sure, it would be fun to have Fortunate 400 status on our resumes, but what's far more important is accumulating and protecting whatever wealth we need to lead the life we hope for. Paying less in taxes is one of the surest ways to protect what we earn. Based on the tax data from the 400ers, long term capital gains should be a top priority for all of us. At OCM, we think careful indexing is the best way to build wealth over the long term...and reduce your tax burden at the same time.

John Osbon, Chief Investment Officer  
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