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## THE NORTHWOOD PERSPECTIVE

### President's Message

*Tom McCullough*

Aaah, summer! I think summer must somehow be more special in Canada because it is so short, and because we have such a long time to look forward to it! And when we arrive at the brink of summer, we can muse, with Lucy Maud Montgomery, "I wonder what it would be like to live in a world where it was always June".

For me personally, the cottage is the penultimate place of relaxation in the summer, and I await the season with anticipation. American philosopher Sam Keen captures my sentiments in his quote: "Deep summer is when laziness finds respectability."

In this issue of *Perspective*, we offer you some summer reading ideas. For those of you who like to use the time to stretch your thinking, we have recently added some interesting articles to our website. You can find them at [www.northwoodfamilyoffice.com](http://www.northwoodfamilyoffice.com) under Resources/Articles of interest. These papers have been written by thought leaders in the industry and cover subjects such as Immigrants and Natives to Wealth, whose author Jim Grubman spoke at a recent family office conference we chaired. Other topics include: Raising Responsible Children with Wealth, Passport Portfolio Diversification, and Strategic Philanthropy.

We are also pleased to introduce our new Northwood Family Office brochure. It is also available on the home page of our website in pdf form, or you can email Mia for copies ([mcassidy@northwoodfamilyoffice.com](mailto:mcassidy@northwoodfamilyoffice.com)). It is a useful tool for explaining the role of a family office and helping families to evaluate their own needs. It also explains the service Northwood offers. Please feel free to forward the pdf to families you think might benefit from being part of the Northwood Family Office.

We are grateful to each one of our clients for the trust and confidence they place in us every day, and to the countless friends and colleagues (many of whom are reading this newsletter) who have supported and encouraged us along the way as we have built Northwood Family Office. Thanks for reading and enjoy your summer!




### Are you Losing Money in Bonds?: Understanding the Tax-Effect

*Eric Weir, CFA, CFP*



Many taxable investors today are literally losing money by buying government bonds trading at a premium to their par values. As with most investments, taxes must be taken into consideration to properly understand the true rate of return a private investor is earning.

While the yield to maturity of a bond is typically the same, whether it trades at a premium, a discount or at par, the impact of taxes is decidedly different. All other things being equal, when an investor buys a bond at a premium to what the bond will be worth at maturity (i.e. par or 100), they only do so because the coupon or rate of interest the bond pays is higher than the rates prevailing in the market at that time. On the surface, that sounds like a pretty fair trade-off – paying a higher premium for a higher-coupon bond. But it is a different story once you take taxes into account!

In Canada, interest income is taxed at the highest marginal rate – higher than the tax rates on dividends and capital gains. So the investor buying a premium bond (and getting a higher coupon in exchange) is shifting more of their total return into the highly-taxed interest income column. When the bond matures, they will of course receive the tax benefit associated with a capital loss (the premium price they paid less par value at maturity), but it won't be enough to compensate them for the highly-taxed interest income they have received. And, unfortunately, in today's low interest rate environment, most bonds do trade at a premium.

#### An Example

An example of this dilemma is illustrated below in the case of a Government of Canada bond.

| Par    | Price  | Before Tax<br>Coupon | Maturity   | Term<br>Remaining<br>(Years) | Total<br>Interest<br>Receivable | Before Tax<br>Yield |
|--------|--------|----------------------|------------|------------------------------|---------------------------------|---------------------|
| 100.00 | 106.04 | 3.75%                | 01/09/2011 | 2.24                         | 8.40                            | 1.21%               |

This bond is trading at a price of \$106.04 and has 2.24 years remaining until maturity. Therefore, based on its yield of 3.75%, an investor purchasing the bond would expect to receive \$8.40 in interest income.

#### The Tax Impact

The \$8.40 in interest income that the investor will receive is then taxed at their top marginal tax rate. Conservatively, we'll assume that a private investor in Canada pays 40% tax on this income. The investor is therefore faced with a tax bill of \$3.36 on the interest income they have earned, leaving them with \$5.04 in after-tax return.

#### Total Return

Although the investor paid, \$106.04 for the bond, they will only receive \$100 when the bond matures, which amounts to a loss of \$6.04 on the bond. This is where the challenge in today's market exists. In the previous section, we calculated that the investor will only receive \$5.04 after income tax has been paid. The investor has therefore lost \$1.00 on this investment for an after tax yield of -0.24%!

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CONTINUED FROM PAGE ONE....ARE YOU LOSING MONEY IN BONDS?

| Assumed Tax Rate | Annual Tax Payable on coupon Interest | Net Coupon After Tax | Total Interest Receivable After-tax | After tax Yield |
|------------------|---------------------------------------|----------------------|-------------------------------------|-----------------|
| 40%              | 1.50%                                 | 2.25%                | 5.04                                | -0.24%          |

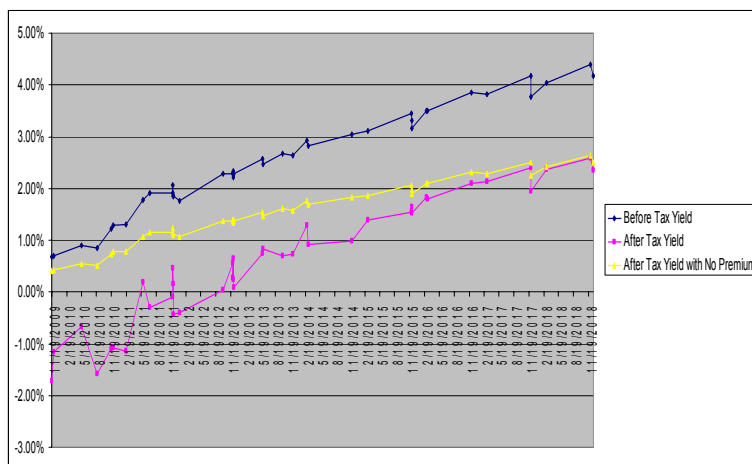
While government bonds are one of the most secure investments an investor can make, taxes have made them an inefficient investment for many private investors, particularly shorter-term bonds.

There is a hidden benefit to this purchase as the loss created can be used against the investor's capital gains. Unfortunately in today's market most investors already have plenty of losses to use, and even if the loss can be used, the benefit generated will not compensate for the taxes owing on the income.

### Today's Market

The majority of government bonds are trading at significant premiums. This includes provincial bonds, to which many private investors have migrated for the added yield pick-up. The chart below shows that, even with the additional yield from the provincial bonds, the majority of the short term bonds will lose money if they were purchased today.

### Provincial Government Bonds – Taxable Yield (40% tax Rate)



## Are you (or a family member) an American citizen?: If so, read this!

Bryan O'Neill Interviews Carol Fitzsimmons, Partner – Hodgson Russ LLP (Federal / International Tax Practice Group)

*We frequently come across individuals with ties to the U.S. - a mixture of U.S. citizens working outside the U.S., and Canadians that either work south of the border or have lived in the U.S. for an extended period of time. While these individuals have traditionally asked us about their income tax return filing obligations, more and more frequently we are being asked about their requirement to disclose foreign bank and financial accounts. In this regard, below is a brief explanation of the U.S. obligation to disclose foreign banks accounts and a discussion with U.S. tax counsel on the filing obligations.*

### Background

Over the last few years U.S. federal prosecutors and the IRS have significantly increased efforts to identify taxpayers who have failed to disclose foreign bank accounts and foreign earned income. This is in attempts to both prevent and identify possible tax avoidance and evasion.

In efforts to encourage individuals (who have failed to properly disclose) to come forward, the IRS instituted a Voluntary Compliance Program, which

### What are the alternatives?

Unfortunately, in today's low interest rate environment there are few compelling alternatives for investing short-term taxable funds. However, there are some ways that investors can ensure they don't lose money and earn some interest income. Below are a few examples for investors to consider without adding too much risk:

- As maturities lengthen, the effect of the premium pricing gradually declines. Taxable investors can carefully select specific bond issues that are trading closer to par.
- Other fixed income investments that are not subject to premium pricing:
  - Bankers Acceptances
  - Floating Rate Notes
  - Commercial Paper
  - GIC's
- Fixed income investments should be located in low-tax or no-tax structures, where possible:
  - RRSP's
  - Lower income spouses
  - Trust structures

### Are these Normal Market Conditions?

We are currently in a historically low interest rate environment, and we expect the current disadvantage to taxable investors to be a short-term challenge. As we return to more stable market conditions and interest rates rise, this disadvantage will be mitigated.

In addition, as new bond issues come to market at coupons which are more reflective of today's environment, investors will hopefully have the opportunity to invest in par or discount bonds without a tax disadvantage.

### Conclusion

Today's low interest rate environment presents a unique set of challenges to taxable investors. They must be very selective in choosing investments that do not put them at a significant tax disadvantage.



allows taxpayers to come forward with information about their previously unreported foreign bank accounts and foreign income.

We posed a number of questions to Carol Fitzsimmons, a partner in the International/Cross-Border Practice Group with U.S. law firm Hodgson Russ LLP:

**Northwood:** In addition to filing their personal tax return (Form 1040), are there any other filing obligations that a U.S. citizen working abroad should be aware of?

**Carol:** Yes, there are several. U.S. citizens who own interests in, or even simply have signatory authority over, non-U.S. bank, investment or similar types of accounts (including investments such as non-U.S. mutual funds and hedge funds) may be required to file Form TDF 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), annually on June 30 with the U.S. Department of the Treasury. Generally, the FBAR is required if the aggregate value of all such accounts exceeds US \$10,000 at any

*CONTINUED FROM PAGE TWO....ARE YOU (OR A FAMILY MEMBER) AN AMERICAN CITIZEN?*

time during the calendar year. U.S. citizens who have interests in non-U.S. trusts may be required to file Form 3520 or 3520A with the IRS annually or on certain "reporting events" such as creation of a non-U.S. trust. U.S. citizens who own stock in, or who are officers or directors of, non-U.S. entities such as corporations or partnerships may be required to file Form 5471 or Form 8865 with the IRS annually. Unfortunately, as you can see, there are many additional forms that may be required by the U.S. government for a U.S. citizen with interests outside the U.S. The forms referenced above are not an exhaustive list, by any means. As well, there are a myriad of different penalties that may apply if these forms, and others like them, are not filed in a timely manner.

**Note:** It is not crystal clear whether a minor with a bank account over US \$10,000 would be liable for failure to file an FBAR.

**Northwood:** What if a U.S. citizen hasn't been filing these forms? How should they proceed?

**Carol:** I suggest they retain a U.S. tax advisor (accountant or lawyer) to determine what forms they should have been filing and discuss an appropriate course of action to correct delinquent filings and comply with the required filings going forward. Right now, the IRS has a Voluntary Compliance Program designed to bring U.S. taxpayers who have not been making required tax filings 'into the fold'. This program is very complex, however, and U.S. taxpayers should seek counsel in these situations to be sure that they are proceeding correctly. More information on this Program, and other U.S. tax information, can be found at:

<http://www.irs.gov/newsroom/article/0,,id=206012,00.html?portlet=7>  
(You may have to copy into your browser)

**Northwood:** What if a U.S. citizen has not been filing personal U.S. tax returns at all?

**Carol:** A U.S. citizen is obligated to report and pay U.S. tax on his or her worldwide income regardless of whether he or she may reside outside the U.S. A U.S. citizen remains subject to U.S. gift, estate and generation-skipping taxes too, even while outside the U.S. In our experience, many U.S. citizens aren't fully aware of what their U.S. tax responsibilities are, and they should seek advice on what to do from a U.S. tax advisor, especially if he or she has not been filing anything with the IRS.

**Northwood:** Do these additional filing requirements only apply to U.S. citizens?

**Carol:** No, they apply to non-citizens who are deemed 'tax residents' of the U.S. Green card holders are automatically deemed to be U.S. tax residents. As well, a Canadian who spends a certain number of days in the U.S. as tested over a 3 year period is generally considered a U.S. tax resident, although, even if this 'day count' is met, there may be exceptions from U.S. residency status that apply under the Internal Revenue Code or the Treaty.

**Northwood:** What about for a Canadian living in the U.S. who is required to file a U.S. tax return?

**Carol:** If the person is a U.S. tax resident, then he or she is subject to these filing rules as well.

In summary, the U.S. filing requirements can be rather complicated and onerous. Therefore, if you are thinking about whether you are required to file or how to make a voluntary disclosure, please first seek out the advice of U.S. tax counsel.

## Summer Reading Selection

Tom McCullough, MBA, CIM, Ch.P

At the family office conference in Banff this past May, we asked each of the speakers to mention one of their favorite books. We thought we'd include a partial list from the conference (plus a few additions of our own) in this newsletter for those of you looking for your summer reading. Enjoy!

### Fiction

- The Girl with the Dragon Tattoo – Stieg Larsson
- Ireland: A Novel – Frank Delaney
- Tipperary: A Novel – Frank Delaney
- Christ the Lord – Anne Rice
- 1776 – David McCullough

### Psychology/ Communication

- A Whole New Mind – Dan Pink
- Outliers: The Story of Success – Malcolm Gladwell
- Made To Stick: Why Some Ideas Survive and others Die – Chip Heath & Dan Heath



### Biographical

- A Voyage for Madmen: The Tragic Fate of Robert Fitzroy, The Man who Sailed Charles Darwin around the World – Peter Nicols
- Winston Churchill Novels (4) – Michael Dobbs
- The Age of Turbulence – Alan Greenspan

### Historical and Conceptual

- The Panic of 1907 – Robert Bruner
- Against the Gods: The Remarkable Story of Risk – Peter Bernstein
- Capital Ideas 1 & 2 – Peter Bernstein
- Collapse – Jared Diamond

### Social Conscience

- How Starbucks Saved my Life – Michael Gates Gill
- Who Really Cares - Arthur Brooks
- The Life You Can Save: Acting Now to End World Poverty – Peter Singer
- Leaving Microsoft to Change the World – John Wood

### Family

- Raising Resilient Children – Robert Brooks
- Family Wealth: Keeping it in the Family – James Hughes
- Family: The Compact Among Generations – James Hughes





## Banff Family Office Conference: Immigrants and Natives

Scott Hayman, CA, CFP



In May of this year, the second Canadian Private Family Office conference was held at the Banff Springs Hotel in Alberta. This invitation-only conference is sponsored by Insight, a well-known Canadian conference company, for the benefit of single-family offices, and multi-family offices like Northwood. Tom chaired this conference, as well as the inaugural one in September 2008 in Niagara-on-the-Lake, and I was one of the conference speakers.

our website), suggest that 75-80% of Americans (and likely Canadians too) in the upper 2% of economic class, arrived at their economic position *during* their lifetime. In other words, they moved up from a lower economic class to a higher class.

Natives to wealth, on the other hand, are those who were 'born rich' and have no history of transition from lower to higher economic class.

We had some excellent speakers from all over the world. Here is a partial list of the presenters and their topics:

| Speaker  | Topic  |
|--|--|
| David Baxter, Partner<br>Thorsteinssons LLP, Vancouver                       | Taxation Planning for Wealthy Families                                     |
| John Benevides, President<br>Family Office Exchange, Chicago, IL             | Investing Family Wealth in Turbulent Times                                 |
| Jon Carroll, President and CEO<br>Family Office Metrics LLC, New York        | Trends in Family Office Technology   |
| Janet Denhamer, VP Investments<br>Viewpoint Investment, Calgary              | What Functions Should a Family Perform<br>In-House or Outsource?           |
| Lisa Gray, Managing Member<br>grayMatter Strategies, Richmond, VA            | Choosing and Working Effectively with<br>Advisors                          |
| Dr. Jim Grubman, Family Wealth<br>Consulting, Turner's Falls, MA             | Creating Understanding in Families of<br>Affluence                         |
| Scott Hayman, Executive VP<br>Northwood Family Office LP, Toronto            | Developing Standards of Practice for the<br>Multi-family Office            |
| David Lesperance, Barrister & Solicitor,<br>Lesperance & Associates, Toronto | Residence, Citizenship and Domicile<br>Planning                            |
| Linda Mack, President<br>Mack International LLC, Chicago, IL                 | Human Capital: Attracting, Retaining and<br>Motivating Family Office Staff |
| Tom McCullough, President and CEO<br>Northwood Family Office LP, Toronto     | The Management of Private Wealth: An<br>Integrated Approach is Essential   |
| Jeff Pentland, Managing Director<br>TD Capital Private Equity, Toronto       | How to Invest in Private Equity – A Primer<br>for Family Offices           |
| Terry Smith, President<br>Philanthropic Partnerships Inc., Toronto           | Giving in Tough Times: Trends and Tips in<br>Family Philanthropy           |
| Scott Welch, Sr. Managing Director<br>Fortigent LLC, Rockville, MD           | Rethinking Risk and Diversification  |

I'd like to highlight one of the most interesting and well-received sessions. Dr. Jim Grubman is a clinical psychologist, living and working near Boston, Massachusetts. His practice has evolved to the point that the majority of his time is now spent with families of wealth and advisors to those families, helping them deal with the psychological aspects of that wealth.

His talk at the Family Office conference centered on the differences between what he calls 'immigrants to wealth' and 'natives of wealth' and the issues that raises.

Immigrants to wealth are those who arrived at their position of wealth within their lifetime. In fact, Dr. Grubman and his co-author, Dr. Dennis Jaffe, in an article called Immigrants and Natives to Wealth (available on

You can imagine the potential differences in the way these two groups might think and the dysfunctional communication that can result (especially between 'economic immigrant' parents and 'wealth native' children, for instance).

- Economic immigrants (just like geographic immigrants) carry with them their old (say, middle-class) culture as they climb the wealth ladder. They sometimes have trouble adapting to the new wealthier culture and frequently feel like 'imposters' in this 'new world'. "They must often guess how to act, spend, dress, even talk." (Note: All quotes come from the Grubman/ Jaffe article.)
- Another, and possibly more jarring, example of an 'immigrant to wealth' is a mixed marriage of a lower economic class person into a higher economic class family.
- "[On the one hand] wealth's immigrants have experienced economic transition as a positive force: they have lived the American dream of overcoming hardship to achieve the good life. They know *risk* as *opportunity*....Whereas for natives, on the other hand, the family's transition upward may be a vague memory or a distant tale of long ago. Conservative as investors and cautious to preserve their status, they often think of financial risk as more likely to move them down the economic ladder. Because they themselves have no history of overcoming hardship, *risk* is seen as *danger*, not opportunity."
- The fact that 80% of wealthy families attained that level in their lifetime, begs the question 'Why are only 20% natives'? The unfortunate answer is that, in most cases, wealth is not sustained. The parents, it seems, can make the money but they can't teach their kids how to hang on to it. The next generation frequently finds themselves "deported from the land their ancestors struggled to reach."

This is a complex but fascinating issue and Dr. Grubman just scratched the surface in his presentation. But it obviously struck a chord among families and family offices in attendance. If you are interested in reading more, you can find the full article on our website under Resources/ Articles of interest, or by clicking this link if you are reading this electronically.

[http://www.northwoodfamilyoffice.com/re\\_articlesofinterest.asp](http://www.northwoodfamilyoffice.com/re_articlesofinterest.asp)



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