



CAPITAL PERFORMANCE ADVISORS, LLC

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Investment Implications of the 2003 Tax Act

The 2003 Tax Act provided much good news for investors. To accurately incorporate all of the provisions of the new Act, we urge investors to consult with us regarding the Act's many nuances (including but not limited to its 2008 sunset clause, varying annual dividend rates and potential impact on the Alternative Minimum Tax). This article more pointedly addresses our view of the legislation's impact on individual investment strategies.

Active vs. Passive Investing

Lower tax rates for all sources of income and long-term capital gains reduce the tax penalty generated by the relatively high turnover of individuals actively/frequently buying and selling mutual funds or individual stocks.

However, it also increases the penalty for active investors relative to passive investors, as the spread has widened between ordinary income tax rates (the rates at which realized short-term capital gains are taxed) and long-term capital gains rates. While the difference between the highest ordinary income tax rate and long-term capital gain rates was 38.6 percent versus 20 percent (an 18.6 percent gap), the difference is now between 35 percent versus 15 percent, respectively (a 20 percent gap).

Avoiding Short-Term Gains

Adopting a tax management strategy that avoids realizing short-term capital gains remains valid in light of the wider spread between ordinary income and long-term capital gains rates.

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The Continued Value of Tax-Managed Investing

Reduced tax on qualified dividends reduces (but does not eliminate) the advantage gained from a strategy of minimizing qualified dividends. ¹ Instead of being taxed as ordinary income, these dividends are now taxed at the same maximum 15 percent rate as long-term capital gains. Of course avoiding even the relatively low 15 percent tax is better than paying it, so some benefit is still to be had from investing one's taxable assets in a fund that pursues a strategy of dividend minimization. Lowered tax on dividends may lead to an increase in dividend payouts, further increasing the benefits from a dividend minimization or reduction strategy. However, we would add the caveat that, just as in the past, investors in funds that adopt such a strategy should remain prepared to accept the random tracking error that goes along with it. That is, there may be times that their near-term investment returns from a tax-managed fund might vary from the appropriate benchmark; investors must be prepared to accept this deviation so that it does not cause them to abandon their carefully designed tax-managed strategy.

A Growing Importance for Asset Location

With the lower capital gains rate and a wider gap between income tax and capital gains tax, we place as much or more importance upon each investor's asset location decisions. Whenever possible, tax-efficient equities should be located in taxable accounts (with an exception for tax-inefficient Real Estate Investment Trusts, or REITs²), and tax-inefficient fixed income should be located in tax-deferred accounts. Otherwise, investors experience the following disadvantages by holding equities in tax-deferred accounts:

- s What would otherwise be long-term capital gains end up taxed at the higher ordinary income rate upon withdrawal
- s There are no tax-loss harvesting opportunities
- s The investor cannot eliminate capital gains by donating appreciated shares to charity
- s There is no foreign tax credit for international assets
- s The potential for stepped-up basis upon death is lost

The location issue is so important that investors who cannot hold all their equities in taxable accounts might wish to consider increasing their allocation to value and small-cap stocks, offsetting the incremental risk created by also lowering the overall equity allocation. This can be accomplished in a manner that provides the same expected return (and hence the same risk) while shifting the equity holdings to the more efficient taxable location. For example, consider the following hypothetical investor "Mary" and her \$800,000 portfolio:

Mary decides she needs a 6 percent return to achieve her financial objective. Based upon estimated returns for each asset class, her initial allocation decisions and her stated risk tolerances, Mary's

advisor develops a portfolio comprised of 60 percent equities and 40 percent fixed income.

Mary has \$400,000 in each of her taxable and tax-deferred accounts, but given her 60/40 allocation, she needs to hold \$480,000 in equities (\$120,000 in each of four US asset classes) and \$320,000 in fixed income, resulting in a need to hold \$80,000 of her equities in the tax-deferred account. Note that a portion of her allocation to the small-cap value asset class was placed in the tax-deferred account because it is the most tax-inefficient asset class:

Scenario A – Some Equities Held in Tax-Deferred Account

Taxable Account	Tax-Deferred Account
S&P 500 — \$120,000	Small-Cap Value — \$80,000
Large-Cap Value — \$120,000	Fixed Income — <u>\$320,000</u>
Small-Cap — \$120,000	
Small-Cap Value — <u>\$40,000</u>	
Total — \$400,000	Total — \$400,000

To create a more tax-efficient portfolio, Mary could consider increasing her allocation to small-cap and value stocks while reducing her exposure to large-cap and growth stocks, or even to equities in general, enabling her to move all of her equity holdings into a taxable environment. Following is an example of this potentially more tax-efficient portfolio — with the same overall risk and expected return:

Scenario B – All Equities Held in Taxable Account

Taxable Account	Tax-Deferred Account
S&P 500 — \$60,000	Fixed Income — <u>\$400,000</u>
Large-Cap Value — \$140,000	
Small-Cap Value — \$140,000	
Small-Cap — <u>\$60,000</u>	
Total — \$400,000	Total — \$400,000

Of course, as the “price” paid for having a more tax-efficient portfolio, Mary would now have to accept more tracking error risk, or periods during which her portfolio would not resemble the market. Investors should assess their individual ability to accept this sort of risk, and avoid taking it if they are unable to tolerate it well, otherwise any gain that might be had through increased tax efficiency might well be lost through the expenses of inappropriate trading in response to short-term anxiety.

Remaining Considerations

- s A lowered capital gains tax rate and lowered tax on qualified dividends further reduces any small advantage there may have been to using annuities as equity tax shelters (again, with an exception for REITs²).

- s Lower tax on dividends makes dividend-paying stocks more attractive. Value stocks tend to have higher dividend yields (partly because of their distressed price), thus the penalty for holding them in taxable accounts has been reduced.
- s The lower tax on qualified dividends also means that preferred stocks become more attractive for taxable accounts. At the same time, greater demand for preferred stocks in taxable accounts lowers their yield, making them less attractive for tax-deferred accounts, where investors generally want to hold their fixed income assets anyway, as described above. (While technically equity investments, preferred stocks are considered as fixed income holdings within the portfolio. Because of this characteristic, we would suggest that stretching for yield by taking on the more risky preferred stocks within one's fixed income holdings remains inappropriate for most investors.)
- s Lower ordinary income tax rates reduce the value of the tax shelter provided by residential mortgage debt. This should be taken into consideration when deciding on how to finance a home purchase, as well as when considering the potential for prepaying a mortgage.

As we have illustrated, the 2003 Tax Act has resulted in some modifications in the way investors might consider approaching their investment portfolio, however none of the changes impact the core globally diversified, passive asset class investment approach we continue to recommend for achieving one's investment objectives. As always, we recommended investors consult with their tax advisor regarding the full impact that the legislation might have upon their overall financial planning.

¹ Some types of mutual fund income dividends will continue to be taxed at ordinary income rates in part or in whole under the 2003 Tax Act. For more details, investors should seek the advice of their professional tax consultant.

² In general, REITs are not subject to corporate income tax and thus are not subject to a double-taxation effect as are most other dividends. Therefore REIT dividends do not qualify for the reduced rates under the new law, and thus remain relatively tax inefficient.

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