

The new tax initiative is a reminder to refocus on long-term investment goals.

## TOPICS IN TAX PLANNING

# Tax-Wise Investing – Implications of the 2003 Tax Act

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NATIONAL OPINION IS split over whether this May's tax cut is a triumph of reason or an impressive exercise of political power. For investors, the Jobs and Growth Tax Relief Reconciliation Act of 2003 is important because it:

- reduces the four top income tax rates — effective Jan. 1, 2003 — for individuals, trusts, and estates:
- | from  | to  |
|-------|-----|
| 38.6% | 35% |
| 35%   | 33% |
| 30%   | 28% |
| 27%   | 25% |
- reduces the top long-term capital gains rate for individuals, trusts, and estates from 20% to 15%, effective for sales on or after May 6, 2003; and
  - creates “qualified dividend income,” a new category of investment income taxed to individuals, trusts, and estates at 15%, effective Jan. 1, 2003.

### New After-Tax Yields of Major Asset Classes

High-income investors are now focusing on new after-tax yields for major asset classes. The chart on the next page shows how the Act changes the after-tax yield of some familiar asset classes, favoring maximum growth portfolios over income portfolios by significantly increasing the after-tax yield of equities.

## EXPLORING TRUSTS: A THREE-PART SERIES

In the April issue of *Market Signals*, we began this three-part series with a discussion of the many benefits trusts offer. Part two, in the May issue, looked at choosing the right trust to achieve your goals. The third part, discussing how to choose the trustees that will best meet your needs, has been postponed until the July issue so that we can bring you this article. (To read the first two articles, visit [http://www.northerntrust.com/library/personal/mrkt\\_newsletters/index.html](http://www.northerntrust.com/library/personal/mrkt_newsletters/index.html))

### Reaction to the New Yield Dynamic

How will the marketplace react to this new yield dynamic? Some suggest a strong future demand by taxable investors for dividend-paying stocks, and perhaps a return by issuers to “traditional” preferred stock. With some important exceptions, dividends paid by domestic corporations and “qualified foreign corporations” (including stock/ADR traded on a U.S. exchange) are eligible for the new 15% rate. Not unexpectedly, the generally higher yielding “hybrid preferreds” do not qualify: these hybrids are equities in name only, with payments based on a stream of interest payments from the parent corporation.

Since traditional IRA and pension plan distributions (whether from interest, dividends, or capital gains) are taxed at ordinary income tax rates, investors may allocate taxable bonds to these portfolios — and equities to other personal accounts.

The potential for future appreciation may be more important to total investment return than current after-tax yield. Balanced against the desire for growth is the search for

safety — there will still be investors in high quality tax-exempt bonds.

### Reaction to New Income Tax Uncertainties

As they assess a new yield dynamic, thoughtful investors must also face new extremes of income tax uncertainty. The Internal Revenue Code has always been subject to change — by legislation, regulations, administrative action, and court decisions. What is new is the extent to which basic income tax provisions are now riddled with scattershot effective dates, transitional rules, and sunset provisions, any one of which can be repealed, made permanent, or extended. In today's environment, future *inaction* by Congress — as well as future action — will affect future after-tax investment yield. This is a risk investors must consider.

For example, our new maximum 15% capital gains rate, effective for sales on or after May 6, 2003, currently terminates Dec. 31, 2008. This 2008 “sunset” might be extended — or it might be accelerated into 2005, 2006, or 2007. Investors wanting certainty may “capture” the current 15% rate by recognizing

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long-term gains now. What if an appreciated asset remains attractive from an investment perspective? Investors can “upcost” by selling and then repurchasing all or a portion of a position at the current market price. The wash sale rule (which prevents investors from recognizing losses if they repurchase a security within 30 days) does not apply to gains.

Other investors may not be able to take immediate advantage of the new 15% capital gains rate. Many have substantial capital loss carryforwards that will absorb any gains recognized in 2003. Today’s lower capital gains rates make existing capital loss carryforwards less valuable.

## The New 15% Dividend Rate

Many investors are slowly realizing the new 15% dividend provisions are far less simple than they seem. Key to mastering these rules is recognizing that the new Act favors long-term investors and is much less kind to speculative traders who are “in and out” of the market.

This bias to long-term investors is evident in the capital gains provisions. Under prior law, the maximum long-term capital gains rate (at 20%) was 18.6 points lower than the highest marginal short-term capital gains rate (then 38.6%). Under the Act, short-term investors are even more severely penalized with a maximum short-term

capital gains rate (35%) more than twice the maximum 15% long-term capital gains rate.

The new 15% dividend rules also target investors seeking to avoid the risk of loss. To qualify for the 15% dividend rate, taxpayers (a) must have held the underlying stock for more than 60 days during the 120 day period that begins 60 days before the ex-dividend date and (b) must not be obliged to make “related payments with respect to similar or identical property,” such as in a short sale. Importantly, the required 60 day holding period does not include any day on which the investor diminishes the risk of loss on the underlying

	Maximum Growth Portfolio						Income Portfolio					
	Portfolio Makeup	Before-Tax % Yield	Tax Rate	After-Tax % Yield	Income Amount	Portfolio Percent	Portfolio Makeup	Before-Tax % Yield	Tax Rate	After-Tax % Yield	Income Amount	Portfolio Percent
<b>Before the 2003 Tax Act</b>												
<b>Equities</b>	850,000						300,000					
Recognized Capital Gain		7.00%	20.00%	5.60%	47,600	79.77%		7.00%	20.00%	5.60%	16,800	45.73%
Qualified Dividend Income (S&P 500 Avg.)		1.74%	38.60%	1.07%	9,081	15.22%		1.74%	38.60%	1.07%	3,205	8.73%
		8.74%		6.67%	56,681	94.99%		8.74%		6.67%	20,005	54.46%
<b>Bonds (Interest)</b>												
10-Year AAA Corporate	50,000	3.75%	38.60%	2.30%	1,151	1.93%	300,000	3.75%	38.60%	2.30%	6,908	18.80%
10-Year AAA Municipal	50,000	3.07%	0.00%	3.07%	1,535	2.57%	300,000	3.07%	0.00%	3.07%	9,210	25.07%
<b>Cash</b>												
Taxable Money Market	50,000	1.00%	38.60%	0.61%	307	0.51%	100,000	1.00%	38.60%	0.61%	614	1.67%
<b>Totals</b>	1,000,000				59,674	100.00%	1,000,000				36,737	100.00%
<b>After the 2003 Tax Act</b>												
<b>Equities</b>	850,000						300,000					
Recognized Capital Gain		7.00%	15.00%	5.95%	50,575	76.37%		7.00%	15.00%	5.95%	17,850	45.24%
Qualified Dividend Income (S&P 500 Avg.)		1.74%	15.00%	1.48%	12,572	18.98%		1.74%	15.00%	1.48%	4,437	11.24%
		8.74%		7.43%	63,147	95.35%		8.74%		7.43%	22,287	56.48%
<b>Bonds (Interest)</b>												
10-Year AAA Corporate	50,000	3.75%	35.00%	2.44%	1,219	1.84%	300,000	3.75%	35.00%	2.44%	7,313	18.53%
10-Year AAA Municipal	50,000	3.07%	0.00%	3.07%	1,535	2.32%	300,000	3.07%	0.00%	3.07%	9,210	23.34%
<b>Cash</b>												
Taxable Money Market	50,000	1.00%	35.00%	0.65%	325	0.49%	100,000	1.00%	35.00%	0.65%	650	1.65%
<b>Totals</b>	1,000,000				66,226	100.00%	1,000,000				39,460	100.00%

security. Translation: some hedging strategies will make the 15% dividend rate unavailable to investors. Strategies that apparently will not disturb the holding period include “qualified covered calls” and “significantly” out of the money options.

### **Mutual Fund Investing Under 2003 Act**

In one sense, mutual funds present the ultimate test of how well we understand the new law. When, for example, will a dividend from a mutual fund be qualified dividend income? Will equity funds have qualified dividend income this year? What about money market funds? Do mutual fund dividends get the benefit of the new maximum capital gains rate? For answers, look to what has happened at the fund level.

Capital gains dividends from mutual funds are generally taxed at 15% only if gains at the fund level are attributable to sales on or after May 6, 2003. Equity mutual funds will have capital gains dividends in 2003 only if their capital gains in 2003 exceed their capital loss carryforwards. What about ordinary income dividends? If qualified dividend income has been received at the fund level, then that portion of the fund's ordinary income dividend attributable to qualified dividend income will be taxed at the 15% rate. Money market funds and bond funds will not generate qualified dividend income.

### **Dark Side of Rate Cuts: Deductions Are Worth Less**

Because of the significant capital gains rate cut, capital losses are worth less. Similarly, because of income tax

rate cuts, there is a decline in the value of deductions that offset income — including investment interest, mortgage interest, and charitable contributions.

**Investment interest.** Under prior law, investors could deduct investment expense (including amounts paid in lieu of dividend by short sellers or participants in securities lending) to the extent of their investment income. Now, investors face an unpleasant choice: either excluding otherwise “qualified dividend income” from the investment income equation or losing the benefit of the 15% rate.

**Mortgage interest.** As the after-tax cost of borrowing rises, the desirability of incurring debt decreases.

**Charitable deduction.** Charities and charitable donors are seeing reduced tax benefits for current charitable contributions and existing charitable contribution carryforwards.

Things could be worse. As enacted, the tax cut reduces the four highest income tax rates and expands the brackets for the two lowest rates. It does not exclude an entire category of income from tax (as, for example, the exclusion proposal would have). This distinction is important because the individual income tax charitable deduction is limited by adjusted gross income (AGI). Exclusions reduce AGI; rate cuts and bracket expansions do not.

### **Recompute Estimated Income Tax Payments**

With lower capital gains and dividend rates, individual investors may decide to reduce estimated income tax

payments due Sept. 15 and Jan. 15, giving them more cash in hand. The Treasury Department has already published new withholding tables for wage earners. These schedules are prospective only, increasing the possibility that many individuals will claim significant refunds in 2004. To avoid making an interest-free loan to the IRS (in the form of overpaid income tax), take the time to recompute third-quarter estimated income tax payments, remembering that each investor's estimated income tax situation is different.

To avoid penalties for underpayment of estimated income tax, trusts typically base their estimated income tax payments on last year's tax or on this year's annualized income. For trusts using an annualized income approach, the June 15, 2003, payment takes into consideration income or payments from January through April — a time period prior to the effective date of the 15% capital gains rate. Trusts, like individuals, should reconsider third-quarter estimates in 2003.

In estimated income tax planning, as in general income tax planning, involve income tax return preparers and run the numbers for alternate scenarios. Individuals and trusts can expect additional complexity on their 2003 income tax returns, with new lines on Forms 1099 and Schedule D for income and gains subject to different rates and recognized under different tax regimes.

### **AMT Forever**

Dividends and capital gains taxed at 15% will not increase alternative minimum tax (AMT) liability. This

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tax-favored income is also subject to a 15% rate under the AMT. Other factors, however, such as lower ordinary income tax rates, a larger standard exemption for married couples, and increased state income tax will cause more individuals and trusts to pay AMT in 2003. A small increase in the AMT exemption, effective during 2003 and 2004, is a partial, short-term response.

### The Big Question: What Will the Future Bring?

In a world where the paperback version of the Internal Revenue Code runs on for 14,000 pages, it is no surprise that income tax planning is heavily dependent on tax preparation software. Publishers have not yet created programs reflecting the 2003 Act. Virtually everyone is waiting for regulatory and administrative clarification from the IRS — and for advance versions of the 2003 Forms 1040 and 1041, typically released in the fall. It will be months before tax professionals are fully equipped to analyze specific income tax situations.

Meanwhile, the bare-majority passage of the Act and the desperate financial situation of state finances mean even more federal and state income tax changes may arrive shortly. For example, less than two weeks after President Bush signed the tax bill into law, Congress was considering

### TAKING ADVANTAGE OF THE NEW RULES

To make the most of the 2003 Tax Act:

- Reconsider asset allocation.
- Know which of your securities and mutual funds produce qualified dividend income.
- Think about “capturing” the 15% maximum capital gains rate by reducing concentrations and recognizing long-term capital gains.
- Get expert tax advice before entering into hedging strategies and securities lending transactions.
- Tape the new holding period rules for qualified dividend income to your desk.

legislation to extend the child credit provisions to low-income (too poor to pay income tax) and middle-income (too wealthy to otherwise qualify for the credit) families. Meanwhile, states are tinkering with their tax laws to generate more revenue. California, for example, has passed new anti-Enron tax shelter legislation. Where all of this will end is unclear. By focusing on the current status of the tax law in 2003, investors and their advisors are doing the best they can in uncertain times.

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