



TAX ADVANTAGED EQUITY

WHEN RECOGNIZING LOSSES, HOW MUCH IS ENOUGH?

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While no investor sets out to generate losses, they are a fact of investing. And taxable investors focused on tax management know that losses can provide an opportunity to offset their future tax liabilities, thus increasing future after-tax wealth. Of course, losses must be *recognized* before an investor can benefit from the income and recognized gain offsets.

The significant decline in market values across all asset classes has meant that it has not been difficult for investors to realize significant amounts of capital losses. But it has forced tax-aware investors to consider how much of a recognized loss carry-forward is enough.

FORECASTING FUTURE RECOGNIZED GAINS

The appropriate level of recognized loss carry forwards depends on the potential level of gains that an investor is likely to realize in the future. The Northern Trust Tax Advantaged Equity team has developed a comprehensive asset allocation model that incorporates a number of variables to forecast the amount of future net recognized capital gains. These include the investor's:

- Time horizon;
- Asset allocation;
- Expected total annual returns;
- Expected capital gain realization rates;
- Tax rates; and
- Investment management fees.

The model assumptions were developed using conservative historical standards for a typical taxable investor. The key model assumptions are shown on page 2 and Net Recognized Capital Gains Forecast charts are shown on page 3. A brief description of key Internal Revenue Code sections follows the model assumptions and data.

APPLYING THE MODEL TO DETERMINE HOW MUCH IS ENOUGH

For the purpose of this research, we varied two assumptions (asset allocation and total annual return), while holding the other key assumptions static.

The sample data shown in the Net Recognized Capital Gains Forecast charts was obtained from the model by varying the asset allocation assumptions (conservative, moderate and aggressive) and total annual return assumptions (conservative, moderate and aggressive). The charts show the cumulative forecasted net recognized capital gains at the end of several time periods (10 years, 15 years, 20 years and 30 years) for each combination of asset allocation and total annual return assumptions. In one simulation, if an investor had a 15-year time horizon, a moderate asset allocation and moderate total annual return assumptions, he or she could expect to recognize \$81 of net capital gains based on a \$100 initial investment.

Furthermore, even with a short time horizon (10 years), a conservative asset allocation and conservative total annual return

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assumptions, an investor would expect to realize approximately \$28 of cumulative net capital gains for every \$100 invested. Put another way, an investor with \$10.0 million and a net recognized loss carry-forward of \$2.8 million (28% of total assets) could expect to deplete his or her entire loss carry-forward over the next 10 years.

Clearly, if we extend the time horizon, or if we use more moderate or aggressive asset allocation and/or total annual return assumptions, the forecasted amount of net recognized capital gains increases at a rapid rate. For example, after just 15 years, all scenarios show more than 50% of the original portfolio value in forecasted net recognized capital gains, and after 20 years all but two scenarios show more than 100% of the original portfolio value in forecasted net recognized capital gains. Considering how quickly an investor can exhaust his or her loss carry-forwards using conservative total annual return and asset allocation assumptions, it becomes easy to understand why it is so critical for investors to continue to actively manage their tax situations.

ACTIVE TAX MANAGEMENT CREATES GREATER LONG-TERM WEALTH

An effective tax management strategy requires ongoing vigilance. Even large pools of recognized losses may be depleted in a rather

short period if the investor loses focus on tax management. Further, the current tax legislation, which is set to sunset at the end of 2010, would increase income tax rates and capital gains rates for higher-income taxpayers beginning in 2011. The longer the investor can defer payment of capital gains taxes, the greater the potential opportunity for increasing long-term after tax wealth.

INTERNAL REVENUE CODE SUMMARY

Certain Internal Revenue Code sections, detailed below, describe how capital gains and losses are netted each year, what amount of capital losses can be used to offset ordinary income each year, and finally what happens to recognized capital losses in excess of capital gains and ordinary income limitations. The important concepts taken from the Code are as follows:

- According to the Internal Revenue Code Section 1222, generally, short-term capital gains and losses are grouped and netted against each other to arrive at a net short-term gain or loss, and long-term capital gains and losses are grouped and netted against each other to arrive at a net long-term gain or loss. If one of those classes is a gain and one is a loss, then those are netted to arrive at a single net short-term or long-term gain or loss.

COMPREHENSIVE ASSET ALLOCATION MODEL ASSUMPTIONS

TOTAL ANNUAL RETURN ASSUMPTIONS

(Before Taxes and Investment Management Fees)

	U.S. EQUITY	INTERNATIONAL EQUITY	FIXED INCOME	ALTERNATIVES
Conservative	7.00%	7.00%	3.50%	8.00%
Moderate	8.00%	8.00%	4.00%	9.00%
Aggressive	9.00%	9.00%	4.50%	10.00%

- Equity returns have a 2% dividend yield component (i.e., a U.S. equity return of 7% would be 5% price appreciation and 2% dividend yield).
- As a reference, the 39-year annualized return for the S&P 500 index and the MSCI EAFE Index were 9.3% and 9.0% respectively.
- Fixed income returns are invested in tax-exempt municipal bonds.
- As a reference, the 28-year annualized return for the Lehman Brothers Municipal Bond index was 7.7%.
- The alternatives category is invested 50% in hedge funds and 50% in private equity.

ASSET ALLOCATION ASSUMPTIONS

(Adapted from Northern Trust Investment Policy Committee guidelines)

	U.S. EQUITY	INTERNATIONAL EQUITY	FIXED INCOME	ALTERNATIVES
Conservative	25%	10%	50%	15%
Moderate	30%	15%	35%	20%
Aggressive	35%	20%	20%	25%

- As a reference, the 15-year annualized pre-tax return for the conservative return assumptions and the conservative asset allocation was 5.4%, and the after-tax after-fee (average fee was 58 bps) return was 4.0%.
- The 15-year annualized pre-tax return for the moderate return assumptions and the moderate asset allocation was 6.8% and the after-tax after-fee (average fee was 64 bps) return was 5.0%.
- The 15-year annualized pre-tax return for the aggressive return assumptions and the aggressive asset allocation was 8.3% and the after-tax after-fee (average fee was 71 bps) return was 6.1%.

NET RECOGNIZED CAPITAL GAINS FORECAST

AFTER 10 YEARS

TOTAL RETURN ASSUMPTIONS	ASSET ALLOCATION		
	CONSERVATIVE	MODERATE	AGGRESSIVE
Conservative	\$28	\$37	\$47
Moderate	\$34	\$45	\$56
Aggressive	\$40	\$53	\$66

AFTER 20 YEARS

TOTAL RETURN ASSUMPTIONS	ASSET ALLOCATION		
	CONSERVATIVE	MODERATE	AGGRESSIVE
Conservative	\$76	\$102	\$130
Moderate	\$95	\$128	\$164
Aggressive	\$116	\$158	\$202

- According to IRS Code Section 1211, generally, \$3,000 of ordinary income can be offset by net recognized capital losses (either short-term or long-term).
- According to IRS Code Section 1212, generally, net capital losses not used to offset capital gains and ordinary income in the current taxable year are carried forward and treated as additional capital losses in the succeeding taxable year. This process continues each taxable year until all recognized capital losses are used or the death of the investor, whichever happens first.

While investors are able to offset some income with recognized capital losses (generally limited to \$3,000 per year), the majority of the benefit of these recognized loss carry-forwards may be obtained by offsetting future net recognized capital gains.

DYNAMIC MODEL ASSUMPTIONS

The model's assumptions could be easily adjusted to reflect a specific investor's tax and investment situation. These adjustments could increase or decrease the expected amount of net capital gains

AFTER 15 YEARS

TOTAL RETURN ASSUMPTIONS	ASSET ALLOCATION		
	CONSERVATIVE	MODERATE	AGGRESSIVE
Conservative	\$50	\$66	\$84
Moderate	\$61	\$81	\$103
Aggressive	\$73	\$98	\$124

AFTER 30 YEARS

TOTAL RETURN ASSUMPTIONS	ASSET ALLOCATION		
	CONSERVATIVE	MODERATE	AGGRESSIVE
Conservative	\$148	\$202	\$200
Moderate	\$192	\$264	\$344
Aggressive	\$245	\$340	\$446

recognized over time. For example, if a higher turnover active manager were used in the equity allocations, you could expect that more capital gains would be recognized in shorter periods.

ACTIVE TAX MANAGEMENT REMAINS CRITICAL

The amount of forecasted net recognized capital gains over time is staggering. In the current market environment, it is easy to understand why some investors might believe that they have enough recognized losses to last a lifetime; however, the data from our model suggests that this is likely not the case and that active tax management remains a critical long-term strategy for taxable investors.

If you would like to learn more about this model and how to determine an appropriate level of loss recognition for your portfolio, please contact your relationship manager.

Additional Model Assumptions

- The model assumes the asset allocation is rebalanced annually at the end of each tax year.
- The model assumes the following tax rates for the investor: 35% for short-term capital gains and losses, 15% for long-term capital gains and losses, 35% for taxable income, 15% for qualified dividends and 0% for tax-exempt income. All taxes for income and realized capital gains and losses are paid each year.
- The model assumes the following investment management fees: 0.40% for U.S. equity; 0.65% for international equity; 0.40% for fixed income; and 1.50% for alternatives. All investment management fees are paid at the end of each tax year and reflected in the model output.
- The model assumes each investment category has a certain percentage of the unrealized gains in the portfolio realized each year. It is important to note that this is not turnover; however, the amount of portfolio turnover of the managers in that category will have an influence on the assumption. The percentage for each category is as follows: U.S. equity is 25%; international equity is 35%; fixed income is 0%; and alternatives is 60%. The equity portions correspond to modest levels of turnover that an investor likely would see in the active equity investment category. Alternatives have a high level of realization due to a 50% allocation to hedge funds, where it is assumed that there is a 100% realization of capital gains and losses each tax year.
- The model assumes a breakout between long-term capital gains and losses and short-term capital gains and losses. This is based on the percentage of unrealized gains that are recognized each year. The amount of assumed short-term capital gains rises as the percentage of unrealized gains that are recognized each year increases. This assumption is based on research that suggests that as the turnover level rises, more of the recognized capital gains and losses will be short-term due to a shorter holding period.

Past performance is no guarantee of future results. Periods greater than one year are annualized except where indicated. Return assumptions reflect the reinvestment of dividends and other earnings and are shown before the deduction of investment management fees. Actual portfolio returns would be reduced by investment management fees and other expenses relating to the management of your account. This assumption has been factored in the resulting Net Recognized Capital Gains Forecast illustration results. There is no guarantee that the investment objectives of any fund or strategy will be met. The information in this report has been obtained from sources believed to be reliable, but its accuracy, interpretation, and completeness are not guaranteed. Opinions expressed are current as of the date appearing in this material only and are subject to change without notice.

The information in this paper is general in nature and should not be construed as tax advice. A tax advisor should always be consulted as to how this information affects your particular circumstance.

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