TAX ADVANTAGED EQUITY

IS NOW THE RIGHT TIME TO HARVEST GAINS?

Northern Trust's Tax Advantaged Equity team presents a model to help assess the investment impact of stepping-up the cost basis of a portfolio in 2010.

Mary Lukic, CFP®
Portfolio Manager,
Tax Advantaged Equity

Christopher A. Fronk, CPA, CFA
Senior Portfolio Manager and Strategist,
Tax Advantaged Equity

The markets have rebounded considerably since their lows in late 2008 and early 2009. At that time, markets lost more than half of their value in a little over a year and many investors believed they had realized losses that would last their entire lifetimes. But the significant and rapid market recovery has created considerable realized and unrealized capital gains in investment portfolios for those investors who remained in the market.

These significant portfolio gains – in the midst of a potentially higher tax rate environment – make strategic tax planning even more critical to maximizing an investor's after-tax wealth. The following analysis examines the proposed tax law changes, the impact of higher tax rates on investment performance and potential investment strategies to help navigate these tax issues.

EQUITY MARKETS REBOUND
Returns for major indexes from the date of recent market lows through 6/30/10

INDEX	TOTAL RETURN SINCE LOW	DATE OF RECENT LOW
S&P 500	59%	March 9, 2009
Russell 3000	60%	March 9, 2009
Russell 2000	81%	March 9, 2009
MSCI EAFE	56%	March 9, 2009
MSCI Emerging Markets	106%	November 20, 2008

Source: Factset/Bloomberg

A DECADE OF TAX LAW CHANGES

Beginning in 2001, a series of tax laws were passed that changed the tax rates for ordinary income, capital gains and dividends. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) reduced the highest marginal income tax rate from 39.6% to 35% (rate decrease was gradually phased in over time). Then in 2003, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) accelerated the ordinary income tax rate reduction to 35% and reduced the long-term capital gains tax rate from 20% to 15%. Additionally, JGTRRA mandated qualified dividends would be taxed at the same rate as long-term capital gains (15%), instead of at ordinary income tax rates (35%), after the rate reduction took effect. These rates were scheduled to sunset at the end of 2008, and the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) extended the rate reductions through 2010.

Unless new legislation is passed, these rates will sunset at the end of 2010 and revert back to pre-legislation levels. In 2011, the highest marginal ordinary income tax rate will revert back to 39.6%. Long-term capital gains tax rates will revert back to 20% and the current 15% qualified dividend tax rate will revert back to the higher ordinary income tax rates of up to 39.6% for individuals. These upcoming tax law changes will affect all taxable investors and may potentially affect their investment strategies.

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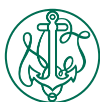

CURRENT TAX PROPOSALS AND TAX LAW CHANGES

Current tax proposals in President Obama's 2011 budget would raise the top two ordinary income tax rates to the pre-2001 levels for high-income taxpayers, and expand the 28% tax bracket so that taxpayers with adjusted gross income under $250,000 married/$200,000 individual would not see their income taxes rise (and may actually see rates decrease). The proposed tax changes would also permanently extend the 0% and 15% long-term capital gains tax rates for taxpayers with adjusted gross incomes up to $250,000 married/ $200,000 individual. A 20% capital gains tax rate would apply to taxpayers above these thresholds. Qualified dividends would maintain the 0% and 15% tax rates for lower-income individuals, and for taxpayers above the $250,000 married/$200,000 individual thresholds, the rate would increase to 20%.

Short-term capital gains have historically been taxed at ordinary income tax rates. Accordingly, under current law, the maximum tax on short-term capital gains is 35%, which is the highest current ordinary income tax rate for individuals, trusts and estates. If the maximum ordinary income tax rate rises to 39.6% in 2011, the maximum tax rate on short-term capital gains would also rise to 39.6%.

In addition to the likely changes to ordinary income, capital gains and dividend tax rates, investors must also balance a new healthcare surtax on net investment income. The Health Care and Education Affordability Reconciliation Act of 2010 mandates a 3.8% surtax on net investment income (includes interest, dividends and net capital gains) that applies to individuals, trusts and estates and is effective in 2013. For individuals, the surtax would be assessed on the lesser of net investment income or the excess of adjusted gross income over the $250,000 married/$200,000 individual thresholds and would be added to the existing dividend and capital gains tax rates (the surtax is calculated differently for trusts and estates).

Although there are more tax rate possibilities, this article and analysis will focus on the current administration's 2011 budget tax proposals.

WHAT THESE HIGHER TAX RATES MEAN FOR INVESTMENT PORTFOLIOS

Whether the President's budget proposals are enacted or current laws are simply allowed to sunset, the various tax rates will inevitably increase at the beginning of next year for high-net-worth individuals. A summary of the current, sunset and Obama 2011 budget proposed tax rates are shown in the table.

TAX RATES SNAPSHOT

HIGHEST MARGINAL TAX RATE CATEGORY	CURRENT	2010 SUNSET	PROPOSED
Ordinary Income	35.0%	39.6%	39.6%
Short-Term Capital Gains	35.0%	39.6%	39.6%
Long-Term Capital Gains	15.0%	20.0%	20.0%
Qualified Dividend Income	15.0%	39.6%	20.0%
Healthcare Surtax	3.8% (effective in 2013)		

Source: Northern Trust, Tax Advantaged Equity Team

Higher tax rates translate into lower after-tax investment performance. The increased capital gains and dividend tax rates negatively affect an investment portfolio's after-tax performance. In order to assess the impact that higher tax rates will have, we compared a portfolio using the current tax rates to a portfolio using the proposed future tax rate structure.

Capital Gains Tax Analysis

In assessing the capital gains tax rate increase, we assume a maximum short-term capital gains tax rate of 39.6% and a maximum long-term capital gains tax rate of 20%. A critical component of this analysis is the estimated annual return assumption. The higher the annual return assumption, the higher the negative impact is on the after-tax rates of return.

Assuming an 8% annualized rate of return, gross of any fees, and a 10-year investment time horizon, an investor at the highest marginal tax bracket can expect to earn 0.34% less each year after taxes due to the increase in capital gains tax rates (see chart). The analysis also shows that the annualized cost of the tax increase decreases each year due to the offsetting benefits of tax deferral until future tax years. The model assumes that 10% of unrealized capital gains are realized each year and, therefore, each additional year of deferral results in a lower tax cost on an annualized basis.

The assumption of a 10% gain realization rate is a conservative estimate that assumes a sizable percentage of a client's asset allocation is in passive strategies. If more assets are held in actively managed strategies, then the gain realization rate could be greater and would further reduce the after-tax returns.

It is evident that in the higher tax rate environment, tax management becomes that much more critical to maximizing an investor's after-tax wealth.

ESTIMATED REDUCTION IN ANNUALIZED AFTER-TAX RATE OF RETURN DUE TO INCREASED CAPITAL GAINS TAX RATES

ANNUAL RETURN ASSUMPTION	TIME HORIZON 1 YR	5 YR	10 YR	20 YR	30 YR
3%	–0.15%	–0.14%	–0.14%	–0.13%	–0.13%
5%	–0.25%	–0.23%	–0.22%	–0.21%	–0.21%
8%	–0.39%	–0.36%	**–0.34%**	–0.31%	–0.30%
12%	–0.59%	–0.53%	–0.48%	–0.42%	–0.40%

Model Assumptions:
Short-term capital gains rate of 39.6% and long-term capital gains rate of 20%.
10% of unrealized capital gains are realized each year.
75% of all realized gains are long-term and 25% are short-term.

Dividend Tax Analysis

We also analyzed the potential tax rate increases for dividends to assess the negative impact on after-tax dividend yields. The chart below compares the after-tax dividend yields of the current dividend tax rates to the proposed 20% and the sunset 39.6% tax rates. If current legislation is allowed to sunset, the tax rate increase will have a significant negative impact on an investor's after-tax wealth.

For example, assuming rates sunset and a 3.00% dividend yield, an investor in the highest marginal tax bracket would earn 0.74% less annually after taxes simply due to the dividend tax rate increase (after-tax dividend yield is 2.55% using a 15% tax rate and 1.81% using a 39.6% tax rate). A differentiating point between capital gains and dividends is that in order for an investor to incur a capital gain, a security must be sold, unlike in the case of a dividend tax where the investor is taxed upon receipt of the dividends.

AFTER-TAX DIVIDEND YIELDS AT POTENTIAL DIVIDEND TAX RATES

DIVIDEND TAX RATE		PRE-TAX DIVIDEND YIELD 1.0%	2.0%	3.0%	4.0%	5.0%
Current	15.0%	0.85%	1.70%	**2.55%**	3.40%	4.25%
Proposed	20.0%	0.80%	1.60%	2.40%	3.20%	4.00%
Sunset	39.6%	0.60%	1.21%	**1.81%**	2.42%	3.02%

The additional 3.8% healthcare surtax effective in 2013 will have an added adverse effect on after-tax performance. It is evident that in the higher tax rate environment, tax management becomes that much more critical to maximizing an investor's after-tax wealth.

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IS NOW THE RIGHT TIME TO HARVEST GAINS?

Due to the significant impact of higher tax rates, some investors are wondering whether now would be a good time to realize long-term gains. Realizing long-term gains in 2010 would reset the cost basis of the portfolio while long-term capital gains tax rates are still at the lower 15% rate. Other investors are wondering whether they should more aggressively harvest losses since these losses will become more valuable in the coming years.

Northern Trust's Tax Advantaged Equity team has developed a model to help assess the investment impact of stepping-up the cost basis of a portfolio in 2010. The model also provides guidance on ways clients can develop investment strategies to better cope with the upcoming higher tax rate environment. The model is based on assumptions for estimated future annual rates of return, beginning unrealized gain positions and future gain realization rates.

The base scenario (Step-up) assumes that an investor realizes all of her/his long-term unrealized capital gains in 2010 at the 15% long-term capital gains tax rate and continues to hold the portfolio for the long-term (future long-term capital gains would be taxed at a rate of 20%). In the second scenario (No Step-up), the investor chooses not to step-up her/his basis and holds her/his portfolio static. Both scenarios include the effect of the 3.8% healthcare surtax beginning in 2013.

A Look into the Model Results

Our model shows that with low-to-moderate return assumptions, it could be beneficial to step-up the basis of an investor's portfolio. For example, if we assume a $25 million portfolio with $15 million of unrealized long-term gains, an 8% annual return, and an annual realization of 10% of unrealized capital gains, then the after-tax market value of the Step-up strategy would be $400,000 more in year three than if the investor did not step-up her/his basis.

However, the benefit of the Step-up does not last over longer time periods. For example, if this portfolio were liquidated after 15 years, the Step-up strategy would have an after-tax market value of $380,000 less than the No Step-up strategy. The results of this analysis highlight the risk of stepping-up the basis for long-term investors, especially when future annual returns are average or above average. Further, it illustrates the benefits of the long-term deferral of the payment of taxes.

Another potential risk of lower after-tax liquidation market values in a Step-up strategy is in the case of death. Step-up is not beneficial if the investor dies, because there is a step-up at death (except in 2010), and the investor would pay capital gains taxes that would otherwise have been avoided.

ANALYSIS OF STEP-UP VS. NO STEP-UP WITH LONG-TERM TIME HORIZON

ANNUAL RETURN ASSUMPTION	MARKET VALUE BENEFIT AT LIQUIDATION					
	YR 1	YR 3	YR 5	YR 10	YR 15	YR 30
3%	$660	$610	$620	$670	$730	$1,010
5%	$640	$540	$490	$430	$420	$590
8%	$620	**$400**	$244	($90)	($380)	($1,540)
12%	$580	$170	($180)	($1,140)	($2,420)	($12,140)
15%	$540	($30)	($580)	($2,320)	($5,120)	($35,780)

All dollars are in thousands.

Model Assumptions:
The initial portfolio market value is $25,000,000.
The portfolio has an initial unrealized long-term capital gain of $15,000,000.
All realized gains are long-term with a 15% tax rate in 2010 and a 20% tax rate in all subsequent years.
10% of unrealized capital gains are realized each year until the liquidation year.
Positive values imply the Step-up option is preferred.

The following summarizes additional model trends.

- As the rate of return increases, the number of years in which the Market Value Benefit at Liquidation is positive decreases.
- At lower rates of return (5% or less), the positive Market Value Benefit at Liquidation of the Step-up extends into the long term (30 years).
- Although not shown in the chart on the preceding page, at lower levels of unrealized gains, the Market Value Benefit at Liquidation of the Step-up is minimal. Additionally, at low levels of unrealized gains and average or above-average annual return assumptions, the Market Value Benefit at Liquidation from a Step-up in 2010 disappears after only five years.

If an investor plans to liquidate the portfolio (or raise cash for reallocation) in 2011, short-term capital gains tax rates present potential risks to a Step-up strategy.

SHORT-TERM CAPITAL GAINS TAX CONSIDERATIONS

If an investor plans to liquidate the portfolio (or raise cash for reallocation) in 2011, short-term capital gains tax rates present potential risks to a Step-up strategy. As the investor steps-up the basis of the portfolio or the portion of the portfolio she/he intends to liquidate in 2010, all tax lots associated with this turnover are now reset and will be short-term in nature for the next year. Therefore, if the investor plans on liquidating assets in 2011, the benefit of the long-term capital gain generation in 2010 must be weighed against the cost of potential short-term gain generation in 2011.

The subsequent return (from Step-up to liquidation) has a significant impact on whether the Step-up strategy will be beneficial.

- With negative returns, the market value benefit can be significant because gains are taxed at 15% in 2010; and in 2011, the value of the losses increases with a 39.6% tax rate.
- As the subsequent return increases, the benefits of stepping-up the cost basis decrease.
- If the subsequent return is high enough, the result of stepping-up the cost basis will be negative regardless of the amount of gain in the portfolio. If, however, the investor can retain the stepped-up securities until the securities become long-term, much of this risk could be mitigated.

ANALYSIS OF STEP-UP VS. NO STEP-UP WITH LESS THAN ONE-YEAR TIME HORIZON

SUBSEQUENT RETURN ASSUMPTION	UNREALIZED CAPITAL GAIN					
	$1 MM	$5 MM	$10 MM	$15 MM	$20 MM	$25 MM
–25%	$1,037	$1,328	$1,691	$2,054	$2,418	$2,781
–10%	$507	$744	$1,039	$1,334	$1,630	$1,925
0%	$50	$250	$500	$750	$1,000	$1,250
10%	($491)	($327)	($122)	$82	$287	$492
25%	($1,458)	($1,349)	($1,212)	($1,075)	($938)	($802)

All dollars are in thousands.

Model Assumptions:
The initial portfolio market value is $25,000,000.
The Step-up is assumed to have a 15% tax rate in 2010 and a 39.6% tax rate in 2011.
The No Step-up is assumed to have a 15% tax rate in 2010 and a 20% tax rate in 2011.
Positive values imply the Step-up option is preferred.

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GAIN REALIZATION STRATEGY CHECKLIST

There are many factors that investors should evaluate when tax planning. Tax rates, investment horizon, return assumptions, loss carry-forwards and asset allocation each affect decisions relating to a long-term gain realization strategy.

In a higher tax rate environment, tax management is an especially crucial element in maximizing an investor's after-tax wealth. In general, Northern Trust's Tax Advantaged Equity team's Step-up analysis shows the value of tax deferral outweighs the benefit of realizing appreciated capital gains in 2010, unless the investor has:

- Short-term cash needs;
- A short-term investment horizon; or
- Low future return expectations.

Investors with a long-term investment horizon are more likely to benefit from continued loss harvesting rather than gain generation in the current lower tax rate environment. On the other hand, in the specific case of a short-term investment horizon (less than five years) or low future return expectations, realizing long-term gains in 2010 may prove to be beneficial on an after-tax basis.

Consider Loss Carry-Forwards and Asset Allocation

Loss carry-forward positions and asset allocation must also be considered when tax planning. Typically, an investor will want to retain loss carry-forwards into the future since the loss carry-forwards will become more valuable as tax rates increase. Additionally, tax loss carry-forwards allow an investor to defer the ultimate payment of taxes into the future. As the model results indicate, longer investment time horizons favor the No Step-up strategy (with average or above-average rate of return expectations).

Further, investors with a higher allocation in equity and alternative investments, but less in fixed income, will likely have a greater need for losses and, thus, generally would not be inclined to generate gains to reset cost bases. For investors with a single stock position or a concentrated portfolio, realizing gains may make sense from a risk perspective since diversification benefits may outweigh tax costs in the long run. These investors may want to consider accelerating any near-term (one to three years) scheduled single stock sales to 2010.

CLOSING THOUGHTS

Investors who participated in the market's rapid recovery from its lows in early 2009 have increased levels of unrealized capital gains in their portfolios. These capital gains combined with a potentially higher tax rate environment in 2011 and beyond make strategic tax planning – now more than ever – a critical element in maximizing an investor's after-tax wealth.

In this environment, it is important to have a team of professionals who understand and can help navigate through the various tax and investment issues that can arise. Partnering with an investment tax manager can provide a customized solution that is tailored to each investor's tax and investment objectives.

An investment tax manager can obtain an investor's desired market exposure but – more importantly – can potentially maximize a portfolio's after-tax return. After-tax return maximization can mean implementation of a loss harvesting strategy, or as this article shows, can mean well-planned gain realization strategies. A tax-managed portfolio balances risk and tax management while providing the investor with flexibility around these two objectives.

FOR MORE INFORMATION

Northern Trust's Tax Advantaged Equity team can provide the analysis needed to help you determine whether realizing gains in a lower tax environment may be beneficial in your specific investment and tax situation. To learn more, please contact your relationship manager.

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