



DIVIDENDS' IMPACT ON TAXABLE INVESTORS

A FRAMEWORK FOR DEVELOPING A DIVIDEND-BASED INVESTMENT STRATEGY

**Christopher A. Frank,
CFA, CPA**

Senior portfolio manager and product strategist for the Tax Advantaged Equity product at Northern Trust Global Investments.

**Eric F. Achepohl, CFA,
CPA, CFP®, CIMA**

Chief executive officer of The Benida Group, LLC, a wealth management company, and an adjunct professor at Elmhurst College in Illinois.

Gregory R. Pasiaka, CFA

Portfolio manager for the Tax Advantaged Equity product at Northern Trust Global Investments.

Regularly changing tax laws force investors to continually assess the tax impact of their investment strategies. Dividends and their impact on taxable investors have always been popular topics in the financial press and have been the basis for various investment strategies. A critical aspect of dividend based investment strategies is the tax implications and thus, investors must understand the basics of dividend tax laws. Due to the fact that the treatment and taxation of dividends is different for individuals and corporate entities, this paper will separately discuss each group's rules and rates. These differences suggest that individuals and corporate entities will have different dividend investment strategies. However, regardless of the different tax consequences, both individuals and corporate entities need to consider the concept of dividends as a risk factor. Examining dividends as a risk factor, as used in enhanced indexing and active management, will reveal several additional implications of dividend based investment strategies besides the measurable tax consequences. This paper will discuss both of these topics as well as highlight some important implementation issues of dividend-based investment strategies.

Another consequence of regularly changing tax laws is the need to develop a framework for incorporating new tax laws into your investment strategy. This paper will help investors develop this framework by providing information on the tax and investment considerations of dividends that can be integrated into dividend based strategies. The paper is divided into four primary sections:

1. The first section separately reviews the dividend tax laws for three specific groups of investors; individuals, corporations and specialized trusts.
2. The second section discusses the investment impact of dividends, which is applicable to all groups of investors regardless of the differences in their specific tax laws.
3. The third section discusses methods to implement dividend based strategies while also focusing on key portfolio construction considerations.
4. The fourth and final section integrates the first three sections into a framework for developing dividend based investment strategies.

In the end, investors will have a better understanding of how to integrate dividends into their investment strategy and how to avoid critical mistakes that can significantly reduce after-tax assets. It is important to remember that each taxpayer's situation is unique and only their tax advisor will be able to fully integrate all of the tax information from their various investment strategies. 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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DIVIDEND TAX LAWS FOR INDIVIDUALS

The tax law for individuals is regularly changing as there is always a political tug-of-war over who should pay what and when. One of the more recent changes was the Jobs & Growth Tax Relief Reconciliation Act (JGTRRA) of 2003. Regarding dividends, JGTRRA states that dividends received by an individual shareholder from domestic and qualified foreign corporations¹ generally are taxed at the same rates that apply to capital gains (15% for high income taxpayers). Prior to JGTRRA, dividends were taxed at ordinary income tax rates and long-term capital gains were taxed at 20% (these rates will apply again for 2011 if the act is not extended). The rate change does not apply to dividends paid by the following:

- Credit unions, mutual insurance companies, mutual savings banks, farmers' cooperatives or tax-exempt cemetery companies
- Any corporation that is exempt from federal income tax
- Stocks owned for less than 61 days during the 120 days before and after the stock's announced ex-dividend date (61 day ownership provision)
- Investments, such as short sales, that require a related payment in substantially similar or related property (applicable for securities lending)

and *may not apply* to the following:

- Real estate investment trusts (REITs)
- Securities owned by an employee stock ownership plan

The rate change applies for purposes of both the regular tax and the alternative minimum tax. Thus, under the provision, dividends are taxed at rates of 5 (zero, in 2008 for low income taxpayers) and 15 percent (high income taxpayers). The provision applies to dividends received in taxable years beginning after 2002 and extending through 2010 (note these rates were originally set in JGTRRA and then extended under the Tax Increase Prevention and Reconciliation Act — TIPRA of 2005).²

Certain provisions in JGTRRA have important implications for the typical taxable investor. The 61 day ownership provision is designed to stop short-term investors from buying a security, holding it until the dividend is paid and the stock price decreases by the dividend amount, selling it, and then receiving the preferential tax treatment. The preferential tax treatment would be the 15% tax rate for the qualified dividend and then a 35% tax rate for a short-term loss (assuming the security price did not change except for the decline based on the dividend payment). Another provision states that the capital gain rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property. This impacts securities that are part of a securities lending program and out on loan. The payment (also called a manufactured dividend) received from a securities lender for a dividend paid on a security that is out on loan does not receive the qualified dividends treatment as this is not a true dividend payment. The current owner of the security (not the lender of the security) receives all of the rights of ownership including the qualified dividend. The impact of this rule is that the original owner (lender) of the security will pay tax at a rate of 35% (assuming

the highest marginal individual tax rate) on the payment or manufactured dividend received from the securities lending agent. Until the current qualified dividend rate sunsets, investors must realize that there is a 20% higher tax rate on manufactured dividends relative to qualified dividends.

Individual investors must understand this concept to properly evaluate the investment value of a securities lending program.

The exclusion of certain REIT income from qualified dividend treatment introduces an interesting analysis on the after-tax value of REIT income. For instance, compare an individual investor's after-tax value of \$100 dollars earned by a REIT to the after-tax value of \$100 earned by a non-REIT corporation. Table 1 below shows how \$100 earned by the different entities flows through to an individual investor's after-tax assets. Because REITs are generally not taxed on distributed income, the table shows that an individual investor actually keeps more of the income earned by a REIT (\$65) than by a corporation (\$55). This highlights the impact of double taxation on dividend income for investors. It also suggests that even though REIT distributions generally do not receive qualified dividend status, the after-tax value to individual investors may actually be greater. This analysis is tax focused and does not consider the possible impact from an investment perspective. A good understanding of these provisions will impact the implementation of a dividend tilt strategy.

Corporation A Income	\$ 100	REIT A Income	\$ 100
Corporation A Tax Rate	35%	REIT A Tax Rate	0%
Corporation A Taxes Paid	\$ (35)	REIT A Taxes Paid	\$ –
Corporation A Income After Tax	\$ 65	REIT A Income After Tax	\$ 100
Corporation A Dividend Distribution	\$ 65	REIT A Dividend Distribution	\$ 100
Individual's Dividend Received from Corp. A	\$ 65	Individual's Dividend Received from REIT A	\$ 100
Individual's Qualified Tax Rate	15%	Individual's Ordinary Income Tax Rate	35%
Individual's Taxes Paid	\$ (10)	Individual's Taxes Paid	\$ (35)
Individual's Income After Tax	\$ 55	Individual's Income After Tax	\$ 65
Total Taxes Paid (Corporation A and Individual)	\$ (45)	Total Taxes Paid (REIT A and Individual)	\$ (35)
Effective Tax Rate	45%	Effective Tax Rate	35%

DIVIDEND TAX LAWS FOR CORPORATIONS

The rules that apply to corporations (including Insurance Assets and Non-Qualified Decommisioning Trusts) are generally quite different from those that apply to an individual. Unlike an individual, a corporation does not receive a preferential tax rate for long-term holdings. In addition, a corporation cannot use recognized losses to offset other forms of income, such as dividend income, while individuals can use capital losses to offset up to \$3,000 of ordinary income. This can be relatively more beneficial for individuals. However, unlike an individual investor, corporations benefit from the dividends received deduction (DRD). The DRD is a tax deduction on the dividends received by a corporation from companies in which it has an ownership stake. The purpose of this deduction is to soften the consequences of triple taxation and is similar in intent to the preferential tax rate of 15% that an individual receives on qualified dividends.³

The size of the DRD is different for varying levels of ownership interest. If a company owns less than 20% of another company, it is able to deduct 70% of the dividends it receives. If the company owns more than 20% but less than 80% of the company paying the dividend, it is able to deduct 80% of the dividend received. If it owns more than 80% of the dividend-paying company, it is allowed to deduct 100% of the dividends it receives. Generally, for investment portfolios, a corporation will own less than a 20% stake and will therefore use the 70% deduction. The rules follow as such: Corporation A pays a \$100 dividend to Corporation B. Corporation B owns less than a 20% stake in Corporation A, so they receive the 70% deduction. That means that only \$30 ($\$100 \times 70\% = \70) will be included as income and will be taxed at the corporate tax rate (35% in 2008). This effectively means that the tax rate on qualified corporate dividends (in their entirety) is 10.5% (30% of the dividends received are taxed at 35% or $30\% \times 35\% = 10.5\%$).

Similar to individuals, certain provisions of the Internal Revenue Code (Code) tend to have a greater impact on corporate investors. For example, under Code section 243, 244, or 245, the DRD is not allowed with respect to any dividend on stock that is held for 45 days or less during the 91-day period surrounding the ex-dividend date. This provision is designed to stop short-term investors from buying a security, holding it until the dividend is paid and the price decreases by the dividend amount, selling it, and then receiving the preferential tax treatment. The preferential tax treatment for a corporation would be the effective DRD tax rate of 10.5% for the qualified dividend and then a 35% tax rate for a capital loss (assuming the security price did not change except for the decline based on the dividend payment). Corporations could then manufacture a tax benefit based on the concept that only 30% of the dividend is included as income, but, 100% of the realized loss is treated as an offset to capital gains.

Similar to individuals, corporations do *not* qualify for the preferential tax treatment (DRD) on certain dividends received from REITs. Again, the exclusion of certain REIT income from qualified dividend treatment introduces an interesting analysis. For instance, compare a corporation's after-tax value of \$100 dollars earned by a REIT to the after-tax value of \$100 earned by another non-REIT corporation. Table 2 below shows how \$100 earned by the different entities (Corporation A and REIT A) flows through to the corporation's after-tax assets. The table shows that the

TABLE 2: ILLUSTRATIVE EXAMPLE OF DIVIDEND INCOME – CORPORATIONS

Corporation A Income	\$ 100	REIT A Income	\$ 100
Corporation A Tax Rate	35%	REIT A Tax Rate	0%
Corporation A Taxes Paid	\$ (35)	REIT A Taxes Paid	\$ –
Corporation A Income After Tax	\$ 65	REIT A Income After Tax	\$ 100
Corporation A Dividend Distribution	\$ 65	REIT A Dividend Distribution	\$ 100
Corporation B Dividend Received from Corp. A	\$ 65	Corporation B Dividend Received from REIT A	\$ 100
Dividends Received Deduction	70%	Dividends Received Deduction	0%
Net Dividend Received (30% subject to tax)	\$ 20	Net Dividend Received (100% subject to tax)	\$ 100
Corporation B Tax Rate	35%	Corporation B Tax Rate	35%
Corporation B Taxes Paid	\$ (7)	Corporation B Taxes Paid	\$ (35)
Corporation B Income After Tax	\$ 58	Corporation B Income After Tax	\$ 65
Total Taxes Paid (Corporation A and B)	\$ (42)	Total Taxes Paid (REIT A and Corporation B)	\$ (35)
Effective Tax Rate	42%	Effective Tax Rate	35%

corporation actually keeps more of the income earned by a REIT investment (\$65) than by another corporation (\$58). This highlights the impact of double taxation on dividend income for corporations (triple taxation if Corporation B ultimately pays the dividend to its shareholders). It also suggests that even though REIT distributions do not qualify for the DRD, the after-tax value to corporations may actually be greater. Again, this discussion is tax focused and does not consider the possible impact from an investment perspective.

Similar to individuals, another provision states that the DRD is not allowed for dividends to the extent that the corporation is under an obligation to make related payments with respect to positions in substantially similar or related property. This impacts securities that are part of a securities lending program and out on loan. The payment (also called a manufactured dividend) received from a securities lender for a dividend paid by a security that is out on loan does not receive the DRD as this is not a true dividend payment. The current owner of the security (not the lender) receives all of the rights of ownership including the qualified dividend. The impact of this rule is that the corporation that lends the security will pay tax at a rate of 35% on the payment (manufactured dividend) received from the securities lending agent. An example will help illustrate this point and quantify the potential impact on performance. Assume that a portfolio with a 3% dividend yield is part of a securities lending program. If one half of the dividends received on this portfolio are manufactured dividends, then this will cost the corporation 36.7 basis points in additional taxes. The reason is that a manufactured dividend yield of 1.5% will be taxed at 35% and cause 52.5 basis points of tax cost. If the corporation received these payments as qualified dividends, and hence were allowed to use the DRD, then these dividends would be taxed at an effective tax rate of 10.5%, a tax cost 15.8 basis points. The 36.7 basis points of additional taxes paid (52.5 bps less 15.8 bps) is because the corporation forfeits the dividends received deduction. The after-tax yield for the corporation assuming it receives the full DRD is 2.69%. The after-tax yield drops approximately 15% to 2.32%, if the corporation receives half of its dividends as manufactured dividends. Corporate investors must understand this concept to properly evaluate the investment value of a securities lending program.

Another relevant consideration regarding the DRD is how it works in conjunction with loss harvesting. For example, assume that an investor acquires security ABC for \$100 and 45 days thereafter it pays out a \$1 per share dividend. Assume the ex-dividend stock price was unchanged except for the \$1 dividend payment, so the stock now trades for \$99 per share and the investor sells ABC for a \$1 per share loss. The investor now has \$1 per share of qualified dividends (assuming ABC was held for 46 days of the 91 days surrounding the ex-dividend date) and a \$1 per share capital loss. However, of the \$1 per share of qualified dividends, only \$0.30 per share ($\$1 \times 70\% \text{ DRD} = \0.30 of income) is taxed at a rate of 35%. This creates a tax cost of (\$0.105) per share. On the other hand, the entire \$1 per share of capital loss will provide a tax benefit of \$0.35 per share ($\$1 \text{ loss} \times 35\% \text{ tax rate}$). The net benefit to the corporation equals \$0.245 per share ($\$0.35 \text{ benefit} - \0.105 cost), but this assumes that the security can be sold and repurchased at the same price.⁴

DIVIDEND TAX LAWS FOR SPECIALIZED TRUSTS

The tax laws for certain specialized trusts such as Personal Injury Settlement Trusts and Qualified Nuclear Decommissioning Trusts are unique. Relative to individuals and corporations, a completely different set of tax laws apply to these types of trusts. From a dividend perspective, the laws for each of these trusts are fairly straightforward. For 2008, dividends are taxed at a rate of 35% in Personal Injury Settlement Trusts and 20% in Qualified Nuclear Decommissioning Trusts. In

fact, all dividend income, interest income and capital gains are taxed at those rates. There is no dividends received deduction; there are no preferential qualified dividend tax rates and no differences between long-term or short-term capital gains and losses. The different tax treatments create two important implications. First, similar to a corporation, realized capital losses cannot be used to offset dividend income. However, unlike a corporation, these trusts do not qualify for preferential tax treatment such as the dividends received deduction. Therefore, compared to corporations, the value of one dollar of dividends received by a specialized trust is less because the entire dividend is taxed at 35% for Personal Injury Settlement Trusts and 20% for Qualified Nuclear Decommissioning Trusts. Second, since the tax rates for dividends and capital gains are the same, solely from a tax perspective, it is better to have lower levels of dividend income and higher levels of price appreciation. All else equal, these types of trusts would prefer to defer the payment of taxes as far into the future as possible. Since dividends do not receive preferential tax treatment for these trusts, a simple tax deferral and loss harvesting strategy may be the best way to maximize after-tax assets.

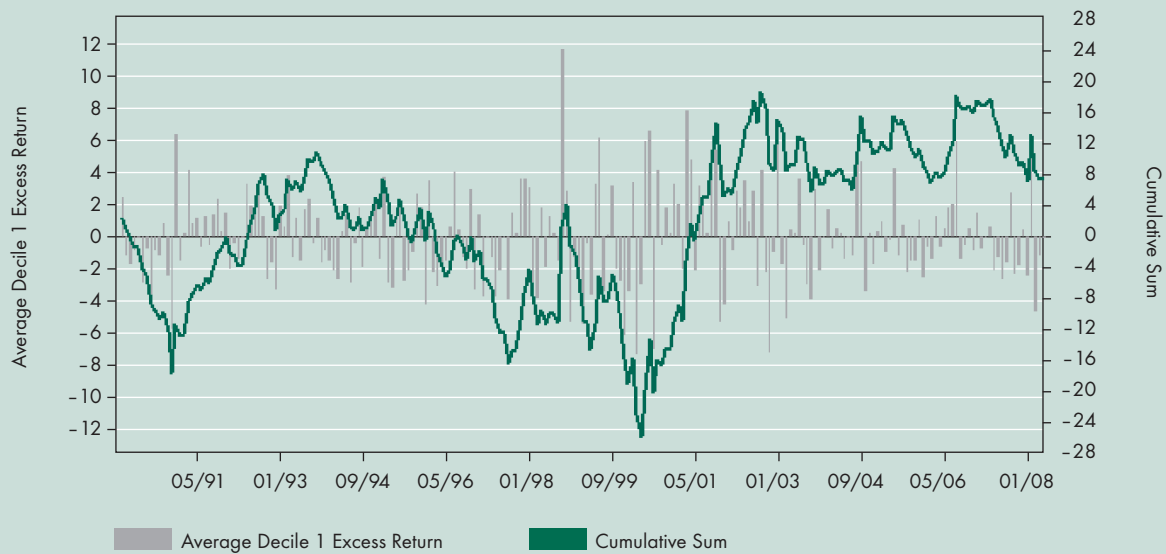
INVESTMENT IMPACT OF DIVIDENDS

In addition to the tax impact, it is also very important to consider the investment impact of a dividend yield tilt strategy. Dividend yield is a **risk factor** that has been shown to explain historical returns. Enhanced index managers and active managers often use the dividend yield risk factor as an “alpha factor” because they believe it will have an impact on a security’s future performance. These managers determine how to appropriately specify alpha factors in order to create proprietary investment models. The process of specifying is formulating the economic justification, definition and measurement of an alpha factor. The proprietary investment models are then used to build portfolios that are intended to out-perform the benchmark index by taking active bets based on the alpha factors. An optimization program can be used to help build an “optimal” portfolio that incorporates multiple inputs and parameters (factor constraints, maximum or minimum sector weights, etc.) based on the proprietary models.

Many of the same alpha factors appear in different enhanced managers’ proprietary models but each may be specified differently. **Measurement** techniques may differ based on the length of the historical time series used, the weight used for each sub-period (e.g. more recent sub-periods have a greater weight), etc. Furthermore, differences may exist based on the weight of each factor within each firm’s proprietary models. For example, one firm may weight the dividend yield factor within their proprietary model more than another firm, supporting their belief that dividend yield has a strong impact on investment performance. The chart below (Cross-Sectional Average Decile 1 Excess Returns)⁵ shows how a dividend alpha factor has performed since 1990. The alpha factor below is **defined** as the return spread between the top decile dividend yielding stocks in the S&P 500 index and the bottom decile dividend yielding stocks in the S&P 500 index. The chart shows that there are periods of time where this alpha factor has out-performed (late 1990 through early 1994) and under-performed (early 1994 through early 2000). Thus, the investment return associated with a dividend yield tilt strategy is at least partially dependant on how the dividend yield factor performs over the investment horizon.

Factor specification is a key component of a dividend yield tilt strategy. Two reasonable alpha factor specifications produce vastly different results. The chart below showed a dividend alpha factor that was defined and measured using no constraints. Defining and measuring the alpha factor in this way means that upon implementation there would be no restrictions on which securities and how much of each security could be held in the portfolio. Defining the alpha factor this way (no con-

CROSS-SECTIONAL AVERAGE DECILE 1 EXCESS RETURN



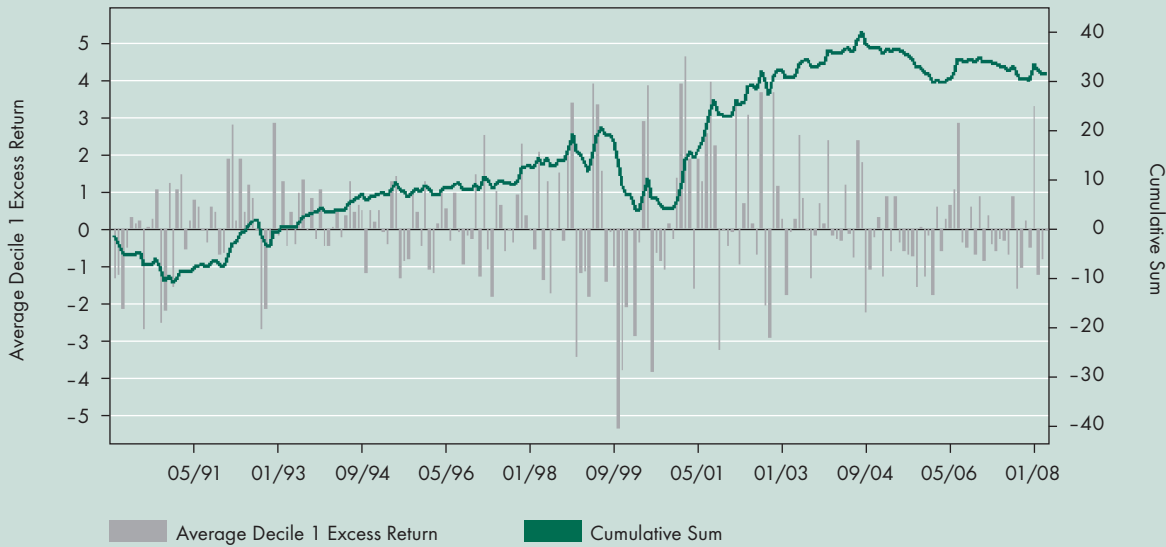
Data provided by Quantitative Services Group, LLC.

straints) allows for the highest possible dividend yield tilt relative to the benchmark. However, this will result in the optimizer favoring high dividend yielding sectors such as financials, utilities and REITs. Thus, in addition to the dividend yield tilt, the portfolio will also have significant sector biases. In this example, these biases will cause the portfolio's overall performance to be driven by sector performance (i.e. the portfolio will do well when financials, utilities and REITs do well).

An alternative way to specify the dividend yield alpha factor is to **define** it as the return spread between the top decile dividend yielding stocks in the S&P 500 index and the bottom decile dividend yielding stocks in the S&P 500 index *by sector*. According to the Global Industry Classification Standard (GICS) there are 10 sectors. Therefore, an alpha factor that is defined by GICS sector classification will have 10 separate decile rankings of securities by dividend yield, instead of just one. Defining the alpha factor in this way has two important implications. First, the change in the alpha factor definition (sector-neutral) changes the historical returns. The chart below (Sector-Neutral Average Decile 1 Excess Return)⁶ shows the same time series as the chart above (unconstrained tilt). However, the historical excess return of the sector-neutral alpha factor shows a very different pattern and is less driven by sector rotations.

The second implication of defining a sector-neutral dividend yield alpha factor is that the maximum dividend yield target of the portfolio is less than that in the unconstrained case. This is because the sector-neutrality constraint "limits" the optimization program from maximizing the dividend yield. For example, assume Security XYZ has a dividend yield of 6.00% and this is the highest dividend yielding security in the benchmark index. If the alpha factor is defined with no constraints, the highest possible dividend yield for a portfolio is 6.00%, a 100% investment in Security XYZ. However, if the portfolio is to maintain sector-neutrality, then the highest dividend yield for a portfolio with this benchmark will decline as additional securities with lower dividend yields are added. Therefore it is important to understand the goals and objectives of

SECTOR-NEUTRAL AVERAGE DECILE 1 EXCESS RETURN



Data provided by Quantitative Services Group, LLC.

a dividend yield tilt so that you can determine the optimal implementation of the strategy.

IMPLEMENTING DIVIDEND BASED STRATEGIES

Whenever considering a material change to your asset allocation, such as a dividend yield tilt, it is imperative to consult with the appropriate advisors to ensure that the portfolio provides the intended investment and tax results. A financial advisor or consultant can explore various methods for how to implement a dividend based strategy, the cost of the various strategies and the interaction with the rest of your asset allocation. A tax advisor can provide background on current tax rates and rules, and possible future tax law changes. An investment manager can provide background on how to implement a dividend based strategy, the corresponding dividend yield, the possible costs (tax and transaction) of modifying a strategy now or in the future, and the estimated and actual performance deviations from your benchmark index. Failure to consult with each advisor could create significant investment and/or tax costs in the form of lower investment returns and/or higher tax consequences.

There are many ways to increase the dividend yield in your overall asset allocation. Working with your financial advisor or your consultant is typically the best place to start. One of the more straightforward and cost efficient ways to increase your dividend yield is to invest in an index that has a higher dividend yield such as the S&P 500 Value index. As of 3/31/08, using Standard & Poor's definition, the dividend yield on the S&P 500 Value Index is approximately 3.00% and the dividend yield on the S&P Growth Index is approximately 1.50% (S&P 500 Core Index dividend yield is about 2.25%). As a shortcut, some investors may invest in the S&P 500 Value Index to increase their dividend yield by 0.75% versus the core index and 1.50% versus the growth index. While this strategy may provide a higher dividend yield, it has the important side effect of creating a value tilt. Similar to our review of the impact of dividend yield as a risk factor, value is also a common risk factor. In

these cases, a value tilt may be an unintended bet. Further, the value-based index may also have other unintended bets to industries, sectors or risk factors.

The significance of a value tilt has long been appreciated by active investors, such as Benjamin Graham who was one of the most influential and well known value investors. Graham believed that stock market participants must make a fundamental distinction between investment and speculation. In his book *Security Analysis*, he stated “An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.” Graham wrote that stock ownership directly translates into part owner of the underlying business. With that perspective in mind, the stock owner should not be too concerned with erratic fluctuations in stock prices, since in the short term, the stock market behaves like a voting machine, but in the long term it acts like a weighing machine (i.e. in the long run its true value will be reflected in its stock price). Graham’s investment strategy also focused on dividend yield investing as he was an advocate of dividend payments to shareholders rather than businesses keeping all of their profits as retained earnings. Graham believed that if companies pay all of their earnings out as dividends then the specifics of financial accounting and possible manipulation of books becomes irrelevant. You may or may not believe in Graham’s philosophy, but if you use a value based index only to increase your dividend yield, then you may be exposed to unintended investment strategies or beliefs.

Instead of using value indexes as a proxy to increase dividend yield, other index providers such as Dow Jones, Mergent, S&P and Morningstar have developed indexes for investors to use that are specifically focused on dividend yield. For example, the Mergent Dividend Achievers50 Index has a dividend yield of 6.54% (as of 6/30/08) and the S&P High Yield Dividend Aristocrats Index has a yield of 5.22% (as of 6/30/08). These dividend focused indexes have very specific selection criteria for index members, which could create unintended bets similar to investing in a value index. These unintended bets will likely have an impact on investment performance. If one of these standard index based products is appropriate for your overall investment strategy, then this may be a more cost effective approach than a custom strategy. A financial advisor or consultant can recommend if any of these indexes match your overall investment goals. If not, another alternative is to use a separate account vehicle to create a custom strategy.

IMPLEMENTING CUSTOMIZED DIVIDEND BASED STRATEGIES

A custom separate account is another implementation method that you can use to increase dividend yield, but there are a couple of key points to consider. First, you need to determine where you will increase dividend yield within your overall asset allocation. Will it be within the large cap, small cap, domestic, or international allocation? Larger, more mature companies tend to have higher dividend yields. For example, the 3/31/08 dividend yields for S&P 500 Large Cap Index, S&P 400 Mid Cap Index and the S&P 600 Small Cap index are 2.25%, 1.60% and 1.55%, respectively. Second, the investment manager needs to understand if investments such as REITs should be included in the dividend yield tilt. REITs typically have a higher dividend yield than other equities. For example, the 14 REITs in the S&P 500 (as of 3/31/08) have an equal weighted average dividend yield of 4.14% and the yield of each REIT exceeds the 2.25% dividend yield of the index. However, if the goal of the tilt is to increase the “qualified dividends” received from the portfolio, then holding REITs will not help as they generally do not produce qualified dividends as previously described. In this case, the manager may keep a neutral weight in REITs and attain an increase in dividend yield from other non-REIT equities.

Another important consideration is how the dividend tilt will impact the portfolio's factor, sector and size exposures relative to the target index. It is important to realize that even small dividend yield tilts may likely cause differences between your portfolio's return and the return of the underlying index. Dividend yield can be modestly increased without a large impact to the portfolio's factor and sector exposures. However, in order to increase dividend yield by a more meaningful amount (e.g. 50 basis points), the investment manager needs to relax the constraints that maintain sector and factor neutrality, which can increase the expected tracking error. Taken to the extreme, the highest level of dividend yield possible is equal to the highest dividend yielding stock in the index. In most situations, investors are not looking for single stock dividend yield enhancement strategies. Therefore, the target level of dividend yield needs to be set at a reasonable level considering the level of estimated tracking error that is acceptable to the client and the consultant.

Regardless of the strategy taken to add a dividend tilt to a portfolio, one must ensure the dividend yield data is accurate and usable. Ideally, dividend yield strategies should focus on the best estimate of the expected future dividend yield of a company, taking into consideration any possible dividend cuts. The liquidity crisis of 2007–2008 has forced companies to look for ways to rebuild depleted capital and one way to do this is to reduce the amount of cash paid out as dividends. Therefore, dividend yield calculations based on the past four quarters of dividends paid may not be appropriate when future dividends have been cut. In this environment it is very important to incorporate future dividend cuts into how a company's dividend yield is calculated. Furthermore, the dividend yield calculation should only include dividends that are reasonably expected to recur and should not include special one-time dividends. The importance of data integrity related to the dividend yield calculation cannot be underestimated since it could negate all of the potential benefits of the strategy.

DEVELOPING A FRAMEWORK FOR INTEGRATION STRATEGIES

Individuals and institutional investors should develop a framework or process for which they can incorporate the ever changing tax laws into their investment strategies. In addition to the investment considerations we have previously discussed, taxable investors must incorporate multiple tax rates and rules within their framework. The following are some tax rules that must be considered for 2008:

35% Tax Rate applies to the following:

- Highest marginal ordinary income tax rate for **individuals**
- Non “qualified dividends” for **individuals**
- Short-term capital gains (holding period of less than 1 year) for **individuals**
- Highest marginal tax rate for **corporations**

15% Tax Rate

- “Qualified dividends” for **individuals**
- Long-term capital gains (holding period of more than 1 year) for **individuals**

Specific rules that could impact a tax strategy:

- \$3,000 of net realized capital losses (short or long-term) can be used to offset ordinary income; remaining capital loss is carried forward indefinitely for **individuals**
- Wash/sale rules regarding securities sold at a loss for **individuals** and **corporations**
- Holding period rules regarding qualified dividend status for **individuals** and **corporations**
- Dividend received deduction for **corporations**

The tax laws create opportunities for investors to develop strategies that take advantage of favorable tax rates and treatments. Investors must analyze how the interaction of these tax rates and rules impacts their investment strategies. The following are some examples of how an individual or corporation can take advantage of favorable tax laws within their investment strategies.

Integrated Strategy for Individuals

The current tax rate for an individual for both qualified dividends and long-term capital gains is 15% (set to end after 2010), while the tax rate for short-term capital gains is 35%. An individual can use all realized capital losses to offset realized capital gains but can only use up to \$3,000 of realized net capital losses to offset income and dividends. Even though the current qualified dividend tax rate of 15% is the same as the long-term capital gains tax rate, there are three reasons why it may be better for an individual to avoid high yielding strategies and to generate income by selling long-term holdings instead of receiving qualified dividends. First, an individual can use realized capital losses to offset an unlimited amount of capital gains but only \$3,000 of dividend income. Second, *the individual controls* the realization of the long-term capital gains whereas dividend payouts are controlled by the corporation. Finally, after 2010 the qualified dividend tax rate will revert back to the higher ordinary income tax rate of 39.6% while the long-term capital gains tax rate will only revert back to a tax rate of 20%. Therefore, after 2010, the individual's tax cost would be lower if income is generated from selling long-term holdings than from dividends. Thus, an individual that is looking for an income stream over the long-term may want to focus on a total return investment strategy and simply raise cash when necessary by selling long-term holdings.

An example will help illustrate the previous point and quantify the potential impact on performance. The table below shows the estimated taxes paid for a portfolio that has a dividend yield of 4%. In 2008, this portfolio will pay approximately 0.60% in taxes assuming the entire dividend yield is comprised of qualified dividends. Assuming there are no tax law changes and the current tax legislation sunsets at the end of 2010, this same dividend yield of 4% will cost the highest tax bracket investor 1.58% in taxes. This represents an increase in the taxes paid by the investor of almost 1% and a reduction of almost 30% in after-tax dividend yield. This will likely mean that any tax benefit this portfolio may have provided to the investor prior to 2011 will be lost when the tax laws sunset back to the 2001 tax rates. If an investor decides to implement a dividend yield tilt, then they must understand the potential tax implications coming in 2011.

Integrated Strategy for Corporations

The most important tax rule regarding dividends received by a corporation is the dividends received deduction. If this rule were changed, then any dividend yield strategy would have to be reconsidered since the corporation actually pays a lower tax rate on dividend income (10.5% as

TABLE 3: CHANGE IN TAX COST FOR A DIVIDEND YIELD TILT STRATEGY

	2008 Tax Year	2011 Tax Year
Dividend Yield	4.00 %	4.00 %
Percent Qualified Dividends	100.00 %	n/a
Qualified Dividend Tax Rate	15.00 %	39.60 %
Taxes Paid (Impact of Dividends)	0.60 %	1.58 %
After-Tax Dividend Yield	3.40 %	2.42 %
Tax Increase Due to Sunset of Qualified Dividend Tax Rate		0.98 %

calculated on page 4) than on capital gains (35% for the highest marginal tax rate). This means that all else equal, a corporation would want a higher percent of its annual investment return from dividends because of the lower effective tax rate. To demonstrate the importance of this, assume a corporation has two investment choices over the next year. Strategy A has a 10% total return solely from price appreciation while Strategy B has a 10% total return comprised of 6% price appreciation and a 4% dividend yield. On an after-tax basis, Strategy A will have a return of 6.50% (3.50% was paid for taxes, 10.00% times the 35% tax rate). However, on an after tax basis, Strategy B will have a higher return of 7.48% (2.52% was paid for taxes, 6.00% times the 35% tax rate plus 4.00% times 1 minus the DRD of 70% times the corporate tax rate of 35%). This illustrates that the DRD can create significant after-tax return for corporations, almost 1% in this example.

An important consideration is that dividends force a corporation to pay taxes in a given year if the dividends cannot be offset by operating expenses. On the other hand, corporations control when they realize capital gains and, thus, when they pay taxes. The example above showed the after-tax return of the higher dividend yield strategy was higher because of the DRD over a one year time horizon. However, a corporation with a longer time horizon should consider which strategy (higher dividend yield or higher price return) is better on an after-tax basis. As the time horizon increases, the benefit from the tax deferral of the higher price return strategy becomes greater. An example will help illustrate this point.

The table below shows two hypothetical investment strategies (Value and Core). Both strategies start with the same market value and have the same estimated annual total return of 10%. However, the Value Strategy has a higher dividend yield (3.0%), while the Core Strategy has a lower dividend yield (2.0%). The “Annualized Return” row shows the annualized return of each strategy assuming that the portfolio is liquidated at the end of that year. The table shows that the benefit of the lower effective tax rate on dividends is strongest in the early years. The after-tax return of the Value Strategy is 25 basis points higher than the Core Strategy after one year, as shown in the last row. However, the relative out-performance decays over time (e.g. compare Year 1 to Year 30) and the rate of decay will be driven by the key assumptions shown at the top of the table. Furthermore, this example does not consider the impact of turnover and historically the Value Strategy (higher dividend yield) has had a higher level of turnover. This will have a negative impact on the after-tax return and may make the Core (tax deferral) strategy more valuable on an after-tax basis. The Jeffrey and Arnott article “Is Your Alpha Big Enough to Cover its Taxes” suggests that even small amounts of turnover can have a significant negative impact on after-tax returns. In either case, the data shows that a corporation must consider the dividend yield strategy when developing and reviewing its broader investment objectives.

ILLUSTRATIVE COMPARISON OF A VALUE STRATEGY AND A CORE STRATEGY

Assumptions:	Value Strategy	Core Strategy		Value Strategy	Core Strategy
Estimated Total Rate of Return	10.0%	10.0%	Corporate Tax Rate	35.0%	35.0%
Estimated Dividend Yield	3.0%	2.0%	Initial Investment	\$100	\$100
Implied Price Appreciation	7.0%	8.0%			
Dividends Received Deduction	70.0%	70.0%	(Ownership assumed to be less than 20%)		
Effective Tax Rate on Dividends	10.5%	10.5%	(Assumes all dividend qualify for DRD)		

Value Investment Strategy:	Year 1	Year 2	Year 3	Year 4	Year 5	Year 10	Year 15	Year 20	Year 25	Year 30
Beginning Market Value	\$100.0	\$109.7	\$120.3	\$132.0	\$144.7	\$229.8	\$364.8	\$579.1	\$919.4	\$1,459.6
Total Return for Year	10.0	11.0	12.0	13.2	14.5	23.0	36.5	57.9	91.9	146.0
Price Return	7.0	7.7	8.4	9.2	10.1	16.1	25.5	40.5	64.3	102.1
Dividend Yield Return	3.0	3.3	3.6	4.0	4.3	6.9	11.0	17.4	27.6	43.8
Taxes Paid on Dividend Yield	0.3	0.3	0.4	0.4	0.5	0.7	1.2	1.8	2.9	4.6
Cash Reinvested from Dividends	2.7	2.9	3.2	3.5	3.9	6.2	9.8	15.6	24.7	39.2
Ending Cost Basis	102.7	105.6	108.9	112.4	116.3	142.2	183.3	248.6	352.2	516.7
Ending Market Value	109.7	120.3	132.0	144.7	158.8	252.0	400.1	635.2	1,008.4	1,600.9
Capital Gains	7.0	14.7	23.1	32.3	42.4	109.8	216.8	386.6	656.2	1,084.2
Taxes on Capital Gains	2.4	5.1	8.1	11.3	14.9	38.4	75.9	135.3	229.7	379.5
Liquidation Market Value	107.2	115.2	123.9	133.4	143.9	213.6	324.2	499.9	778.7	1,221.4
Annualized Return	7.24%	7.32%	7.40%	7.48%	7.55%	7.88%	8.16%	8.38%	8.56%	8.70%

Core Investment Strategy:	Year 1	Year 2	Year 3	Year 4	Year 5	Year 10	Year 15	Year 20	Year 25	Year 30
Beginning Market Value	\$100.0	\$109.8	\$120.5	\$132.3	\$145.3	\$231.8	\$369.7	\$589.8	\$940.8	\$1,500.8
Total Return for Year	10.0	11.0	12.1	13.2	14.5	23.2	37.0	59.0	94.1	150.1
Price Return	8.0	8.8	9.6	10.6	11.6	18.5	29.6	47.2	75.3	120.1
Dividend Yield Return	2.0	2.2	2.4	2.6	2.9	4.6	7.4	11.8	18.8	30.0
Taxes Paid on Dividend Yield	0.2	0.2	0.3	0.3	0.3	0.5	0.8	1.2	2.0	3.2
Cash Reinvested from Dividends	1.8	2.0	2.2	2.4	2.6	4.1	6.6	10.6	16.8	26.9
Ending Cost Basis	101.8	103.8	105.9	108.3	110.9	128.2	155.9	200.1	270.6	383.0
Ending Market Value	109.8	120.5	132.3	145.3	159.5	254.5	405.9	647.5	1,032.9	1,647.7
Capital Gains	8.0	16.8	26.4	37.0	48.6	126.2	250.0	447.4	762.4	1,264.7
Taxes on Capital Gains	2.8	5.9	9.2	13.0	17.0	44.2	87.5	156.6	266.8	442.7
Liquidation Market Value	107.0	114.7	123.1	132.3	142.5	210.3	318.4	490.9	766.1	1,205.1
Annualized Return	6.99%	7.08%	7.17%	7.26%	7.34%	7.72%	8.03%	8.28%	8.49%	8.65%

Value Strategy Better/(Worse)	0.25%	0.24%	0.23%	0.22%	0.21%	0.17%	0.13%	0.10%	0.07%	0.05%
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Developing a strategy that has the flexibility to change with the tax laws and developing a process to monitor the impact of current and proposed legislation are critical success factors for the taxable investor.

CONCLUSION

Currently, there is uncertainty regarding the extension of the qualified dividend tax rate set to expire at the end of 2010 (sunset provision). If it is allowed to expire then the 2001 dividend tax laws will apply. This potential for change can make it difficult for investors to get comfortable with any dividend strategy based on current tax laws. However, all tax rules for both individuals and institutional entities are subject to possible changes regardless of a sunset provision. This means that any tax based investment strategy may need to be adjusted over time, which will likely create costly taxable transactions that must be considered. Developing a strategy that has the flexibility to change with the tax laws and developing a process to monitor the impact of current and proposed legislation are critical success factors for the taxable investor.

Although one may think that dividend strategies are straight forward and intuitive, they are actually quite complex and have nuances that must be considered. Dividends' impact on taxable investors creates opportunities for both tax savings and profit. Some of the examples discussed herein show that the potential costs of poor tax planning can range from a 0.25% to 1.00% reduction in after-tax performance. Consequently, both individuals and institutional entities should consider the tax rates and rules when developing an investment strategy. The tax impact should be a major consideration for taxable investors but not the sole deciding factor. Financial advisors, consultants and tax advisors need to work closely together to make sure that the potential benefits of any investment strategy are not completely negated by increased tax costs.

NOTES

1. The term “qualifying foreign corporations”, includes any foreign company trading on a U.S. securities exchange, incorporated in a U.S. possession, or incorporated in a country where certain treaties with the U.S. are in effect.
2. The following are select excerpts from major enacted tax legislation since 2000. The select excerpts are provided by The Tax Policy Center, which is a joint venture of the Urban Institute and Brookings Institution. The Center is made up of nationally recognized experts in tax, budget, and social policy who have served at the highest levels of government. Additional tax related information can be found at the following website, www.taxpolicycenter.org.

ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001 (EGTRRA)

- Individual income tax rate reductions. When fully-phased in 2006, levied a new 10 percent rate on the first \$12,000 of income for a married couple (\$10,000 for a single head of household and \$6,000 for an individual); the 15 percent rate begins thereafter; reduced 28 percent rate to 25 percent, the 31 percent rate to 28 percent, the 36 percent rate to 33 percent and the 39.6 percent rate to 35 percent. Repealed the phaseout of the itemized deduction and personal exemption by 2008. Made the 10 percent bracket retroactive, resulting in refund checks of up to \$300 for individuals and \$600 for couples 4-5 months hence.
- Child tax credit increase. Doubled the \$500 per child tax credit to \$1,000 and made it refundable for persons earning above \$10,000 to the extent of 10% for every dollar of earned income above \$10,000 up to the maximum per child. The refundability rate rises to 15% in 2005 and the \$10,000 threshold is inflation indexed.
- Marriage penalty abatement. Lowered marriage penalties for couples by making the standard deduction and 15 percent bracket twice the size as for a single taxpayer.
- Estate and gift tax reduction and elimination. Gradually reduced the estate and gift tax rate from 55 percent to 45 percent by 2007; raised the effective exemption from \$1 million in 2002 to \$3.5 million in 2009. Eliminated the estate tax portion entirely in 2010 in lieu of a capital gains tax with high disregard (\$3.3 million) for transfers to a surviving spouse.
- Retirement savings contribution ceiling increases. Increased IRA annual contribution limits from \$2,000 to \$5,000 and 401(k) limits from \$10,000 to \$15,000; allowed individuals 50 and older to make larger, catch-up contributions; permitted Roth 401(k)s beginning in 2006; and established a temporary credit for retirement savings for households earning \$50,000 or less.

THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003 (JGTRRA)

- Accelerated provisions of EGTRRA (2001). Expanded child tax credit to \$1,000 per child for 2003-04, reverting to present law (2001-enacted phase ins and outs) in 2005; expanded 15 percent tax bracket and standard deduction for joint filers to double the ranges and levels for single filers for 2003-04, reverting to present law in 2005; expanded 10 percent bracket for 2003-04, reverting to present law in 2005; implemented 2006 rate schedule: 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, 35 percent; increases individual AMT exemption amount by \$4,500 single and \$9,000 joint for 2003-04.
- Capital gains and dividends. Taxed capital gains with a 15 percent rate for most gains and 5 percent for gains of moderate income taxpayers for 2003-07; becomes 15 percent/0 percent in 2008 and reverts to present law in 2009. Taxed dividends with a 15 percent/5 percent rate structure for 2003-07, 15 percent/0 percent in 2008, reverting to present law in 2009.
- Depreciation. Increased bonus depreciation or expensing to 50 percent for physical asset purchases for 2003-04, reverting to present law in 2005; increased section 179 (100 percent) expensing by raising expensable amounts from \$25,000 to \$100,000 and the phase-out threshold amount from \$200,000 to \$400,000.

TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005 (TIPRA)

- Depreciation. Extended the increased expensing allowance for depreciable business property from \$25,000 to \$100,000; increased threshold amount for determining reductions to the expensing allowance; and increased the period during which a taxpayer may revoke an election to expense depreciable business property thru 2009.
- Capital gains. Extended through 2010 reductions in capital gains and dividends tax rates (5 percent for taxpayers in the 15 percent bracket and 15 percent for others) enacted by JGTRRA (2003).
- Inflation adjustment. Accelerated the inflation adjustment to the exclusion amount for foreign earned income to 2006 from 2008; also, extended through 2008 certain exemptions for income of controlled foreign companies.
- AMT. Increased the AMT tax exemption, last altered in 2004 under WFTRA (2004), to \$42,500 for single filers and \$62,550 for married filers, and extended this thru 2006.
- IRAs and Roth IRAs. Allowed taxpayers to convert traditional IRA balances into Roth IRAs; eliminated the income limit (\$100,000) on Roth IRA conversions starting in 2010.

3. Triple taxation occurs when Company A is taxed on its earnings and then pays a dividend to shareholders including Company B. Company B is then taxed on the dividends it received from Company A (reduced by the DRD if appropriate) and then pays out a dividend of its own to its shareholders including Individual C. Individual C is then taxed on the dividend income preferably at the preferential tax rate of 15% for qualified dividends.
4. In reality, the security will likely be trading higher or lower than the initial sale price and the corporation will have either additional cost or benefit when repurchasing. However, if a corporation executed this style of trading many times in a broad based loss harvesting strategy, the likelihood of a near zero opportunity cost, which is the cost of not owning the security for 31 days, increases. The rationale is that some of the securities sold will go up (cost) and some will go down (benefit) before re-purchase, but on average the overall investment impact is more likely to be zero when the style of trading is executed many times in a broad based loss-harvesting strategy.
5. The lightly colored bars on the chart "Cross-Sectional Average Decile 1 Excess Return" show the monthly return differential between the top decile and bottom deciles of dividend yielding stocks. The alpha factor is defined as the applicable quarterly dividends per share (determined by the ex-dividend date and excluding extra or year end special dividends) for a stock multiplied by 4 and then divided by its month-end trading price. The dark line, which corresponds to the y-axis on the right, shows the cumulative return differential for this alpha factor.
6. The lightly colored bars on the chart "Sector-Neutral Average Decile 1 Excess Return" show the monthly return differential between the top decile and bottom deciles of dividend yielding stocks by sector. The alpha factor is defined as the applicable quarterly dividends per share (determined by the ex-dividend date and excluding extra or year end special dividends) for a stock multiplied by 4 and then divided by its month-end trading price. The dark line, which corresponds to the y-axis on the right, shows the cumulative return differential for this alpha factor.

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