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CAMBRIDGE ASSOCIATES LLC

SUMMARY OBSERVATIONS ON THE 2003 TAX ACT

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SUMMARY OBSERVATIONS ON THE 2003 TAX ACT[1]

Although the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the Act) changes the tax treatment of some types of investment earnings and therefore affects our after-tax expected return assumptions, taxable investors should not assume their long-term investment strategies must therefore be revised. The changes effected by the Act all sunset sometime between now and 2010, making long-term assumptions about future tax rates quite tenuous. We offer no opinion as to whether or not such sunsets will actually occur, but feel quite comfortable in predicting tax laws can and will change again.

The Act clearly favors financial assets over hard assets: while taxes on stock dividends and on capital gains from financial holdings were slashed, the capital gains levy for collectibles, art, antiques, gems, stamps, coins, and bullion remains at 28% and long-term gains on real estate investments still face a depreciation recapture tax of 25%.

Key Provisions

- Long-term capital gains realized after May 6, 2003 are taxed at 15%. (Gains are treated as long-term for assets held more than a year; the 18% rate for assets held longer than five years has effectively been repealed). This rate applies to the alternative minimum tax (AMT) as well as to regular taxes, and expires after 2008. Qualified dividends are taxed at the capital gains rate (again, for both regular tax and AMT purposes). This provision also expires in 2008. To qualify, dividends must be paid from current or prior profits, and come from either a U.S.-based firm or a non-U.S. firm that trades on a U.S. exchange or is incorporated in a country that has a tax treaty with the United States. Investors must hold the shares and be "at risk" (i.e., not holding an offsetting short position, option to sell, etc.) for at least 61 days during a 120-day period that starts 60 days before the stock goes ex-dividend.
- Payments in lieu of dividends (i.e., payments made to stockholders by short-sellers who have borrowed a dividend-paying stock) do not qualify for favorable tax treatment.
- REIT distributions do not qualify for favorable tax treatment, unless they are paid out of income that has already been taxed.
- Corporations still get a 70% deduction for dividends received from other U.S. companies, and pay an effective rate of 10.5% on said dividends.
- Capital gains tax on collectibles, art, antiques, gems, stamps, coins, and bullion remains at 28%.
- Depreciation recapture for real estate remains at 25%.

[1] We would caution readers that individual tax circumstances can vary greatly and that Cambridge Associates is *not* in the business of providing tax advice. These summary observations should therefore be regarded as for general information purposes only.

Investment Implications

The most notable change is the reduction in tax levies on dividends and long-term capital gains. Since the spread between such taxes and those on ordinary income and short-term gains has increased significantly (the top marginal ordinary income tax rate is now 2.33 times the top rate for long-term capital gains and qualifying dividends), the after-tax attractiveness of various asset classes and strategies should be carefully reviewed. Obviously, the relative disadvantage of any strategy that generates most of its return through short-term gains or other ordinary income has been considerably exacerbated. As a result, taxable investors should reevaluate their commitment to those active managers, including active equity managers and all types of hedge funds, whose investment approach generates predominantly short-term gains. Furthermore, the Act also diminishes the economic value of capital losses to taxable investors, as these will now offset lower-taxed capital gains.

The appeal of long-short hedge funds in particular has been reduced, as payments in lieu of dividends are not considered qualified dividends. As a result, hedge funds that borrow dividend-paying stocks from taxable investors will likely need to make investors whole by covering the increased tax bill, thus increasing the fund's cost basis (whenever possible, hedge funds will obviously seek to avoid this by borrowing from non-taxable investors). In addition, there is some concern in the hedge fund community that the Act might constrain the supply of stocks available to short. This is unfounded in our view: a more likely scenario is a slightly higher cost to borrow with little change in supply. While this will make long-short funds slightly less attractive relative to long-only strategies, the change is marginal and should not impact most investors' decision-making process.

Although beneficial to virtually all taxable investors, the new tax laws are not expected to substantially change pre-tax investment return assumptions for most asset classes. The reduction in dividend taxes, for example, has been widely credited with increasing the appeal of equities that pay a dividend, or even of companies that have large cash hoards from which they might pay dividends in the future. However, while this may be true for individual stocks, the reduction in dividend taxes is not necessarily a net positive for equities, and, according to risk-return theory, could even reduce investor demand. The lowering of dividend taxes essentially increases taxable investors' expected return without a related hike in risk. Investors looking to maximize return relative to a certain level of risk, therefore, would not change their allocations to equities based on the Act, as the risk profile of equities has not changed; these investors would simply get a higher return for the same amount of risk. On the other hand, investors looking to generate a specific percentage return with as little risk as possible would likely decrease their equity holdings, as lower dividend taxes now allow them to realize the same return with less risk. Therefore—barring an increase in risk tolerance—the Act would not be expected to increase investors' equity allocations.

The counter-argument, of course, is that the lower tax on dividends means investors need a lower dividend yield to achieve a desired level of return; thus, equity prices should rise to reflect this. Even under this scenario, however, the gains would be short term; once equity prices adjusted to the change, expected returns would return to their prior level. The sunset provisions of the Act introduce another element of uncertainty, and could hamper the market's adjustment process as investors guess whether or not the lower tax rates will remain in effect past 2008. (The Act should have little or no impact on the investment strategy of non-taxable investors. While yields could drop due to lower tax burdens—and thus reduce expected returns—this could very well be offset by companies that choose to boost dividends in response to the lower tax rates.)

The Act does, of course, make equities more attractive relative to other asset classes, but the impact on such assets is likely to be minimal. Municipal bonds, for example, already offer something of a free lunch for top tax-bracket investors: since the supply of tax-exempt bonds outstrips demand from such buyers, munis already yield more than the breakeven yield for those in the 35% tax bracket. In addition, equities and bonds still have different characteristics and are attractive to different investors for different reasons. Even before the Act, equities had a higher expected return than bonds, yet investors still owned bonds for diversification and other purposes. While lower dividend and capital gains taxes may shift the equation slightly, they do not radically alter it.

However, there are some pitfalls investors should be aware of. For example, investors who are tempted to borrow to buy dividend-paying stocks and use the interest expense to offset ordinary income will find that the Act specifically precludes such arbitrage. Investment interest is only deductible to the extent it offsets investment income, and qualifying dividends no longer count as investment income. In addition, various strategies used by individuals to reduce the risk of a concentrated stock position, such as cashless collars and variable prepaid forwards, may result in the dividends of that security not qualifying for the lower tax rate.

Perhaps more than anything else, the Act has introduced multiple uncertainties into the long-term planning process, and has made timing of critical importance for taxable investors. Especially for investors holding illiquid assets such as venture capital or timber, it is important to recognize that future tax rates could be quite different from those now in effect. Investors with the option of putting off a taxable event for several years or taking the tax hit now (e.g., those with concentrated stock positions) should carefully weigh the possibility that rates might change in the interim.

Overall, the Act is clearly a net positive for taxable investors, but should have little effect on long-term asset allocation decisions. In a comment on the Act, U.S. Trust said that planning has now become more of a "timing game" than anything else, and we would agree. What investors actually do, in other words, may be less important than when they do it.