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WHITE PAPER

DIVIDEND TAX CUT
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CONFIDENTIAL – PROPRIETARY

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HIGHLIGHTS

- *Background:* President Bush recently signed into law a new tax package, called the "Jobs and Growth Tax Relief Reconciliation Act of 2003", (JGTRRA). The $350 billion tax package will accelerate all previously enacted individual tax rate cuts, reduce tax rates on capital gains and qualified dividend income, and provide increased incentives for business investment.

  Here is a brief description of the law's tax provisions pertaining to revisions on qualified dividend income:

  The law reduces tax rates on qualified dividend income. Between 2003 and 2008, the law reduces tax rates on dividends – and capital gains – to 5% for the 10% and 15% income tax brackets and to 15% for taxpayers in the remaining tax brackets. The law reduces the 5% rate to 0% in 2008, which means that taxpayers in the lower two brackets will pay no taxes on capital gains and dividends that year. This provision will expire on January 1, 2009. The effective date for the dividend provision is January 1, 2003.

- *Conclusion:* The tax reduction on qualified dividend income increases dividend yield in a meaningful way, but is a temporary fiscal policy change that will expire in 5 years. Beacon Pointe believes that the legislation provides marginal effects on asset allocation decisions, but provides significant financial and tax planning opportunities in regards to the placement of investments in account types classified according to tax status.

Background

- The Jobs and Growth Tax Relief Reconciliation Act of 2003, passed by Congress on May 23rd and signed into law by President George W. Bush on May 28th, represents the third largest tax reduction in the history of the United States. It is intended to provide stimulus to the economy by boosting consumer and business expenditures, rejuvenating the securities markets, and restoring investor confidence by injecting some discipline back into Corporate America.

- The bill primarily affects individual taxpayers, but also has provisions that benefit small businesses by increasing expense deductions and closely held corporations in terms of passive sources of income.

- Potential benefits:

  - Facilitate an economic recovery by stimulating consumer and business spending
    - The Treasury Department says that accelerating the 2004 and 2006 rate cuts beginning in July will provide 32 million taxpayers an average tax cut of $1,060
    - Based upon the multiplier effect
    - Promote increased consumer spending by putting more jingle in the pockets of individuals
    - Leads to increased business spending and investing
    - Ultimately, the tax cuts should boost job creation and economic expansion

  - In the long-run, moves towards a system that taxes consumption more than investment
    - By treating (qualified) ordinary dividend income and capital gains equally, investors have more incentive to invest for the long-term
    - Belief in supply-side economics

  - Discourage bookkeeping games to enhance reported earnings
    - Recent accounting scandals have been largely driven by management efforts to inflate reported corporate earnings
    - Partially caused by different tax treatment of capital gains and dividends for investors whom generally preferred to receive profits from price gains rather than dividends
    - With matching treatment, companies have less of a reason to inflate earnings
    - Issuing regular dividends induces corporations to operate with more discipline since cash flows must be more carefully managed

Market Effects – Valuations

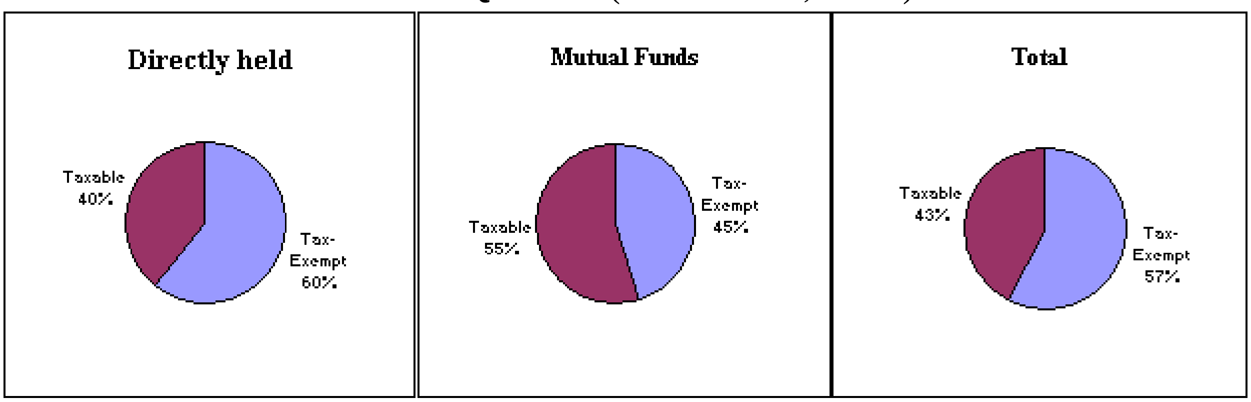
- Reduced taxation levels on dividends may enhance certain types of stocks, specifically those with higher yields or high free cash flows. However, the overall impact on market valuations may be subdued.

- Close to 60% of U.S. corporate equities are held in tax-deferred accounts, such as pension, endowment, and foundation plans. In addition, many mutual funds do not always manage portfolios with taxable investors in mind, making the total share of tax-exempt management actually higher.

- Exhibit 1 below shows an estimated break out of domestically held U.S. securities as of December 31, 2002.

Exhibit 1

DOMESTICALLY HELD U.S. EQUITIES (December 31, 2002E)



Source: Federal Reserve Board and Sanford C. Bernstein & Co.

- Putting the recent bear market aside, dividends have been losing share as a market driver for several decades with price appreciation becoming the dominant driver.

- In a study by Sanford C. Bernstein & Co., price appreciation – capital gains – has accounted for some 85 to 90% of equity returns for much of the 1990s. Compared to a historical breakdown of roughly 60/40 (price appreciation/dividends), the role of dividends as a driver of stock value appears to have faded.

Jobs and Growth Tax Relief Reconciliation Act of 2003 – Details

- Exhibit 2, below, illustrates the new tax rate schedule under the Jobs and Growth Tax Relief Reconciliation Act of 2003:

Exhibit 2

Prior Rates		New Rates*
10%		10%
15%		15%
27%		25%
30%		28%
35%		33%
38.6%		35%

*Retroactive to January 1, 2003

- Exhibit 3, below, illustrates the capital gains and qualified dividend income tax rates under the Jobs and Growth Tax Relief Reconciliation Act of 2003:

Exhibit 3

Ordinary Income	Capital Gains*	Dividend Income**
2003 - 2007		
10%	5%	5%
15%	5%	5%
25%	15%	15%
28%	15%	15%
33%	15%	15%
35%	15%	15%
2008		
10%	0%	0%
15%	0%	0%
25%	15%	15%
28%	15%	15%
33%	15%	15%
35%	15%	15%

*Retroactive to May 6, 2003

**Retroactive to January 1, 2003

Asset Allocation Analysis

- What does all this mean from an investor's point of view? Does the boost to returns for equities dictate substituting equities for bonds?

- Our research suggests that the reduction on ordinary dividends and long-term capital gains rates should not significantly affect asset allocation decisions.

- Our conclusion is based upon revised assumptions regarding before and after-tax expected return and risk profiles underlying our asset allocation model. The results are displayed in the following exhibits.

Exhibit 4

Simulated Portfolio Allocation -- Before JGTRA

Asset Class	Portfolio 1	Portfolio 2	Portfolio 3	Portfolio 4	Portfolio 5
U.S. Equity	40	45	50	55	60
Foreign Equity	10	15	15	20	20
Fixed Income	50	40	35	25	20

Simulated Portfolio Allocation -- After JGTRA

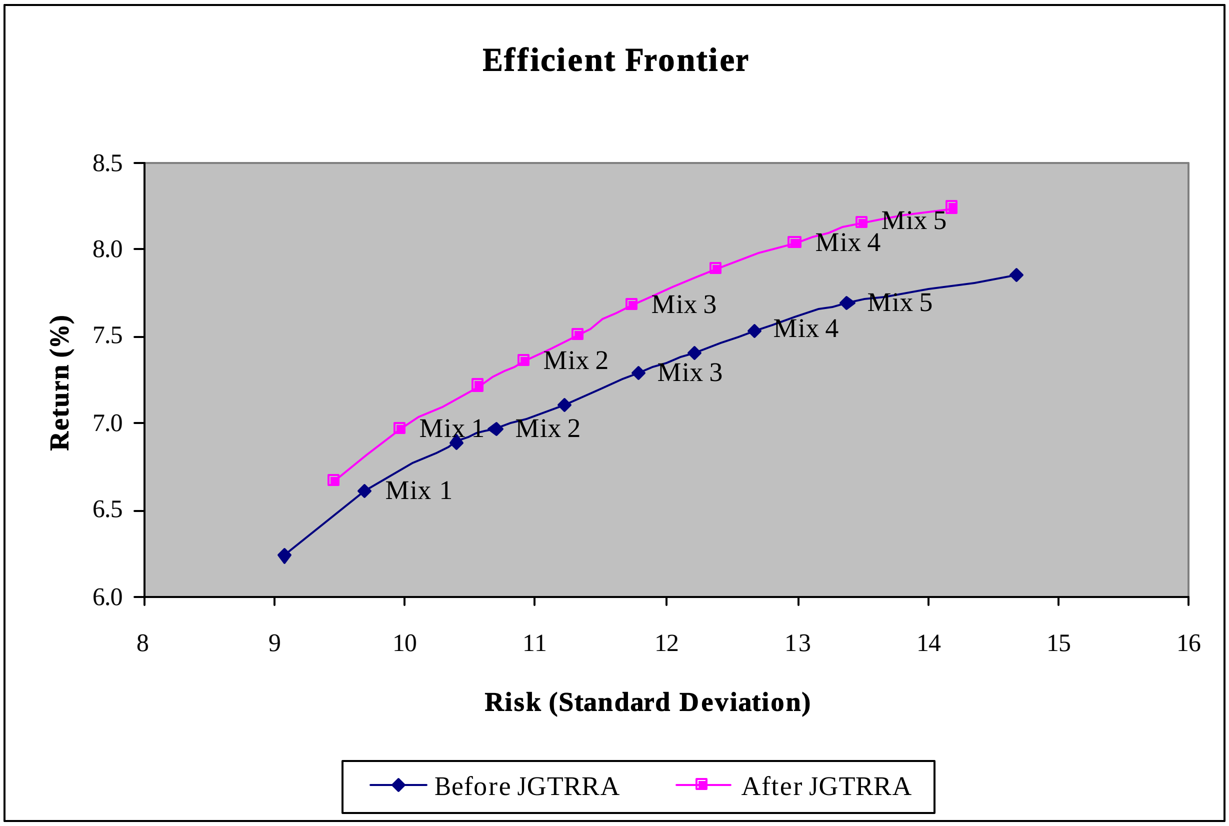
Asset Class	Portfolio 1	Portfolio 2	Portfolio 3	Portfolio 4	Portfolio 5
U.S. Equity	35	45	55	60	70
Foreign Equity	15	15	10	10	10
Fixed Income	50	45	35	30	20

- Although after-tax expected return for U.S. Equities increased by 0.9% by our estimates, the optimized relative weights between major asset classes changed very little.

- The highlighted portfolio mixes (2, 3, and 4), which are the most realistic if common constraints are taken into account, illustrate the minor allocation adjustments proposed as a result of our revised expectations.

- Migration of assets from the foreign equity class into both U.S. equity and fixed income in increments of 5% each is largely due to the uncertainty surrounding treatment of foreign ordinary stock dividends under the JGRRTA.

Exhibit 5



- Since the reduction of taxes affects total after-tax returns for all asset classes, albeit to differing degrees, expected returns increase, causing the efficient frontier to shift upward, almost in a parallel fashion.

- Curiously enough, the 'After JGTRRA' curve is a bit shorter than 'Before JGTRRA' – a sign of compression in portfolio risk, or standard deviation. We posit that because the largest component of the tax cut is aimed at stock dividends, which acts as a stabilizing factor on total returns to equities, the expected deviation in portfolio returns is diminished.

- The following factors, in our opinion, are the primary determinants of the relatively minor effects that the JGRRTA of 2003 has on asset allocation decisions:

    - Although the reduction on ordinary dividends boosts after-tax returns for U.S. equities, especially large capitalization stocks particularly those with high dividend yields, total return returns in recent years have been driven primarily by price appreciation rather than dividend yield.

- The confusion surrounding the qualification of foreign ordinary stock dividends still needs clarification. Consequently, we did not include foreign ordinary dividends as "qualified" under the JGTRRA. As a result, our model indicated reallocation of foreign equities to U.S. equities in the range of 1% to 5%.
- The diversification effects and fixed income stream from bonds remains a relevant factor in portfolio construction and asset allocation decisions. In addition, the lower marginal tax rates also help to increase the after-tax return, if only slightly.

Additional Commentary

- Dividend income received by most investors from domestic and qualified foreign companies in all years from 2003 to 2008 will be taxed at a maximum rate of 15%, while lower income taxpayers will be taxed at 5% from 2003 to 2007, falling to 0% in 2008. However, as there is a sunrise, there is also a sunset. The tax rates under the new bill expire on January 1, 2009.

- While capital gains tax reduction has been a perennial favorite issue on Capitol Hill, the action taken this year was rather unexpected. For sales or exchanges of capital assets on or after May 6, 2003, the new rates drop the maximum long-term capital gains tax form 20% to 15%. Accordingly, the capital gains tax rate for lower income taxpayers decrease from 10% to 5%. In 2008, the 5% rate drops to 0%. As under current tax laws, these lower rates apply for both regular and alternative minimum tax purposes.

- As a result, preferred stock may become more popular compared to comparable yielding debt because of the tax advantage enjoyed by dividends under the new bill. However, preferred stock dividends that are issued in the form of trust do not qualify under the new tax rates.

- Most distributions resulting from REITs will continue to be taxed at the ordinary income tax rate.

- Unlike the last capital gains tax cut in 1997, there is little pent-up gain in the market waiting to be realized. Rather, this seems to be a prospective-looking provision than one aimed at making an immediate impact.

- In addition, carry forward losses from previous years that were realized when rates were higher will be worth less now as they serve to shelter a lower taxable gain.

- Sometimes the proposals *not included* in legislation are as important as what is.

  - "Lifetime Savings Accounts" that would have permitted individual investors to contribute up to $7,500 per year into an account with tax-free income accumulation

  - Permanent repeal of the estate tax

Conclusion

- The reduction of tax rates for dividend income should make high-yielding stocks marginally more attractive relative to both taxable and municipal bonds. Moreover, the after-tax return spread between REITs and annuity investments over higher yielding stocks will also be diminished.

- Investors should consider their overall allocation in terms of the type of account investments are held in. For example, a commonly employed strategy is to hold more equities in tax-deferred or non-taxable accounts so that profits were not exposed to the considerable effects of capital gains and income taxes.

- In general, taxable bonds, REITs, and short-term capital gains investments should be held in tax-deferred or non-taxable (retirement) accounts while high-yielding stocks, municipal bonds, and long-term capital gains investments should be held in taxable accounts.

- Highly appreciated securities that qualify for long-term capital gains rates that are perhaps overweighted, should be considered for sale.

- Given that the gap has widened between short-term and long-term capital gains rates, it is critical that portfolios be monitored to ensure optimization of these capital assets or liabilities. The one-year holding period has become even more critical.

- While the new tax bill made some effort to address the Alternative Minimum Tax (AMT) by increasing the AMT exemption by a small amount, this limited relief is available only in 2003 and 2004. It is extremely important for investors to estimate their tax liabilities under both AMT and regular tax schemes before making major strategic decisions.

- Resident state taxes should play a more significant role because most states do not have special rates for dividends and capital gains, and many states are finding it necessary to increase taxes this year to fund actual or anticipated deficits. Taxpayers living in states with high income tax rates may not benefit as much.

Please feel free to contact your Beacon Pointe consultant if you have any questions.