INVESTMENT STRATEGIES

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Taxing Thoughts: Year-end Tax Strategies

Initial ideas for tax strategies in 2009 and beyond

Changes may be required for investors looking to plan investment tax strategies this year and going forward. We believe there is a high likelihood of future tax increases in order to fund a wide variety of new social programs being proposed by the Obama administration and Congress. Additionally, 15% capital gains and qualified dividend tax rates for high income taxpayers are likely to expire at the end of 2010. The typical tax-loss planning strategies one would use year to year might be modified due to the potential for tax changes on investments that could come down the line. We will attempt to cover some of those potential changes below, as well as discuss the more traditional tax strategies.

Getting Started

This time of year, many people are starting to arrange holiday parties and fill out holiday shopping lists. Tax planning may sound like something that can wait until April 15 rolls around, but we believe virtually all investors (and for that matter taxpayers in general) should consider their tax situations well in advance of year end. Begin planning your year-end tax strategies as early in the year as practical.

We suggest, as a first step, you go through your entire portfolio. Identify any stocks you potentially want to sell based on fundamentals, whether you have a profit or loss. Determine your holding period on each position.

Establishing Tax Losses

Capital losses generated can generally be used to offset any gains on a dollar for dollar basis or up to $3,000 in ordinary income once all gains are offset. For investors in a high tax bracket, the value of a security that has declined sharply can often be more valuable as a tax loss candidate than the security is currently worth.

However, this year (2009) may be a little different should the Obama administration decide to raise taxes in order to pay for some of its initiatives. If the capital gains rate is increased to 20% or 25% in 2010 or later, for example, an investor can save 5% or 10% in taxes by **taking gains** this year instead of waiting until a later date.

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While we believe any increase in the capital gains rate will not occur until 2011 due to the current financial dislocations and the fact that the changes under the Bush tax cuts sunset on January 1, 2011, investors who believe the rate will increase in 2010 under the Obama administration may wish to take gains (assuming one has some) this year and save losses for the future when they may be more valuable (because the deduction may be 20% or 25%).

Investors may also wish to sell positions of stocks that may not fare as well under new legislation that may be coming and establish positions in industries that might do better. As an example, coal companies may not fare as well under laws reducing greenhouse gases. A capital loss can be established or gains realized, while a position in an industry that could do better under such new legislation would be established. As an example, one might sell beaten up oil stocks and replace them with beaten up solar energy stocks.

Double Up, Sell Original Position After 30 Days

In order to take advantage of certain tax maneuvers, one must act well before the end of the year. This includes doubling up on a losing position and selling out the original position prior to the end of the year to recognize a tax loss.

Because of wash sale rules, which require 30 days to elapse between the time you bought the new position and sold the old one, the purchase needs to be made prior to 30 days before the end of the year. Should you choose to utilize this tax planning strategy, remember to sell the original high cost position prior to the end of the year. This may be an appropriate strategy for stocks that have experienced price weakness but whose fundamental outlook appears solid.

While not all industry sectors have seen their stock prices move down this year, there are a variety of individual stocks that are down significantly during 2009. Many of these stocks may be ripe for moves upward towards the end of 2009 due to the impact of the "January effect", and may be good candidates for this strategy.

Sell Now, Buy Back After 30 Days

Sell a losing position now and buy the security back in 31 days -- but you must believe the security will be attractive for purchase a month into the future for this to be an appropriate strategy. A risk to selling the stock now (without buying an offsetting position) is that the stock could potentially run up in the thirty days while the position is not held.

A price run-up could occur in cases of beaten up stocks or industries that tend to be subject to year-end tax loss selling, as well as with the subsequent impact of the "January effect" in which depressed stocks often trade up early in the following year. It is imperative to think about these risks before selling a position you really want to hold.

To limit potential risks, consider purchasing a similar stock when the first is sold. As an example, if you own a pharmaceutical stock and want to sell it now for a tax loss, purchase another pharmaceutical stock to offset the risk of an overall rise in the pharmaceutical sector. While the company you purchase is not going to be exactly comparable to the one you sold, it may react to the same catalysts. Save any company specific issues with either company, the two should move somewhat in tandem.

Either way, it pays not to get too attached to any stock. When the 31st day rolls around, re-evaluate whether or not you want to own the stock. Don't reflexively buy back the stock. If it is too expensive at that time, walk away; there are likely other undervalued stocks around to purchase. **Don't get married to a stock.**

Sell Outright

If the thesis upon which a stock was originally purchased no longer holds, an outright sale of the position with no expectation for buying the stock back may be an appropriate strategy for establishing a loss. This is especially appropriate when looking at stocks and industry sectors that might not do as well under new legislation making its way through Congress.

Selling Gains

If you have stocks in which you have a gain and are considering selling, look at how long you have held them. If you are close to holding them a year, you may want to refrain from selling until you own them a full year plus one day to secure the 15% tax rate versus having them taxed at the top marginal tax rate, which can be as high as 35%. However, remember it is generally better to pay taxes on a gain than to wait and have a loss! **Never let tax considerations be the only determinant in your investment decisions.**

In general, there are two major conclusions. One is, sell losers this year to offset long-term gains. If gains are still short-term at year end and it's unlikely there will be bad news that could drive the stock price lower, wait to sell winners until 2010 after the shares have been held for 12 months. Be careful of the wash sale rules, and don't let these tax considerations drive the investment decision. If the investment should be sold today, sell it today even if you have to pay tax on the sale.

On the other hand, if you expect to be taxed at a lower tax rate this year and a higher tax rate next year, you may actually want to sell your winners this year and hold onto your losers until next year. This assumes the capital gains rate is applicable both years, something that could be an issue for high tax bracket individuals beyond 2010.

Also remember the Alternative Minimum Tax (AMT). Capital gains rates can be higher under the AMT. In general they can be as much as just over 20% versus 15% on long-term capital gains under the regular tax.

Political considerations should also be part of the equation. Should one anticipate a higher capital gains tax rate will occur in 2010 under the Obama administration, one may want to sell this year rather than waiting. Our belief at this point, though, is that the increase will not occur until after 2010, so you might have next year to sell as well.

Also note: ordinary income tax rates are likely to rise going forward for those in the top tax brackets, which could make tax advantaged investments much more attractive. For those in the top tax brackets, municipal bonds in particular could become very attractive. We believe demand for these securities should increase fairly significantly over the coming years and could drive the value of these bonds higher. Therefore, we believe individual bonds or funds that invest in municipal bonds could prove attractive and good investments under the Obama administration.

Mutual Funds

Also understand the same strategies discussed above can be used in considering the sale of mutual funds. In fact, it is often easier to run these strategies with funds. Although their returns are likely to be very similar, selling one technology fund on which you have a loss and buying a different technology fund is typically not a wash sale.

Make sure not to buy a mutual fund that is about to go ex-dividend since you will pay tax on that dividend, which will reduce the value of the fund by the amount of the dividend. Many people reinvest the dividend in new shares anyway, so always buy your funds after any year-end dividend has been paid. If selling, consider selling any fund before the year-end dividend has been paid to escape any short-term capital gain distributions, which are taxable at ordinary income rates.

Caution: Reinvestment elections can act as a trigger to the wash sale rules, preventing your ability to recognize a loss. Be sure to consult a qualified tax advisor regarding this matter.

Dividend Strategies

Taxation of dividends should also play into your investment strategy. For the most part, corporate dividends are now taxed at the same 15% rate as long-term capital gains (except under the AMT, which may also result in a higher tax rate like capital gains). That is not the case with some mainstream, pass-through investments, REITs (real estate investment trusts), certain RICs (registered investment companies), and those classified as BDCs (business development companies). While many investors have been loading up on these investments to gain their high income generating attributes, you may wish to consider purchasing these investments in tax-exempt accounts if possible, while investments generating qualifying dividends are bought in your taxable accounts.

Consider the following: if you have $10,000 in dividends from REITs and RICs in your taxable account and are in the highest tax bracket, you are likely to pay a total of $3,500 in federal taxes. But if you get the same amount in qualifying dividends, you are likely to only pay $1,500 in taxes, a savings of $2,000. Remember, you must meet the holding period requirements to receive qualified treatment on those earnings.

We suggest structuring your portfolio to have companies paying qualified dividends in your taxable account and those with non-qualifying dividends in your retirement or tax exempt accounts. An exception is with a REIT whose dividends tend to be classified as returns of capital. This type of distribution generally is not taxable in the year received, but rather reduces the cost basis of the investment.

In addition, you can also use these types of securities to help control amounts of taxable income reported in a custodial account for minors potentially staying below the threshold which would require the minor to pay taxes at the parents' rate.

Think of Your Retirement Plan

In addition to these recommendations, we feel investors should always max out their retirement accounts. If you want to buy a stock and have not maxed out all of your retirement accounts, consider placing the money in your IRA or Roth IRA first, and then buy the stock there. You still own the stock and are likely to experience a tax benefit. Of course, if your investment objective includes use of those funds before retirement, a taxable account is appropriate.

Remember, deductibility of retirement plan contributions may be impacted by circumstances which can vary from individual to individual. Please be sure to consult your tax advisor. Even if your income does not allow you to have a deductible IRA, you may wish to open a non-deductible IRA for some of your investments.

With the value of IRA accounts probably down significantly at present, it may also be a great year for investors to re-characterize their accounts into Roth IRAs. Under such a transaction, one would pay ordinary income tax on the value of the IRA, and swap the assets into a Roth IRA, where there will be no tax on the withdrawals, rather than paying ordinary tax on the appreciated value of the traditional IRA. Also, unlike a traditional IRA, there is no minimum required distribution requirement under a Roth IRA.

Miscellaneous Thoughts

Be mindful when you re-balance your investments:

- Remember, the sale of a stock, bond (even tax-exempt!) or mutual fund is a taxable occurrence. Consider the timing of your action whether you have a gain or a loss.
- Pay attention to the political situation and what the Obama administration is proposing on income and investment taxes. It is impossible to divine exactly what may be done and when, and it's important to pay close attention to what is being proposed.
- If you hold a large amount of cash, you may want to invest in a Treasury bill now that matures in the following year and pays interest at maturity. In this situation, the interest will not be recognized in the current year.

- Don't forget your miscellaneous itemized deductions. While they have to add up to 2% of your AGI (adjusted gross income) before they are deductible, there could be a large number of them, and most unreimbursed expenses relating to your job and investment advisory expenses may be included. Remember, as your income increases, these deductions are phased out according to IRS regulations. Be sure to consult your tax advisor regarding this matter and possible AMT triggers.
- Remember the needy. Rather than having a garage sale this year, go through your closets and clear out all of your unneeded/unwanted items and donate them to charity. The fair market value of the items is generally deductible against your adjusted gross income if you itemize, and you won't have all the costs and hassles involved in trying to sell the items yourself. It's reasonably easy to find fair market values for your items these days on the Internet [see eBay Inc. (EBAY-$23.34)], and you can help others while saving on your taxes! Be aware, some contributions may require donors to get an appraisal. Keep in mind the effect of the phase-out provisions as your income increases.
- Also remember the popular Qualified Charitable Distribution (QCD) provisions were restored under the financial bailout package. IRA owners subject to required minimum distributions can use this provision to make tax-free distributions to qualified charities with funds that would be otherwise taxable.

A tax advisor or accountant should always be consulted before any tax plan or strategy is implemented.

Additional information is available upon request.

Stocks priced as of close, November 6, 2009.

Analyst Certification

I, John Roberts, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

The author of this report owns a long stock position in the common stock of eBay Inc.

Investment Ratings

Buy - We believe the stock has significant total return potential in the coming 12 months. **Long-term Buy** - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues. **Neutral** - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise. **Underperform** - We believe the stock is vulnerable to a price decline in the next 12 months.

Suitability Ratings

1 - A large cap, core holding with a solid history. **2** - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks. **3** - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage. **4** - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base.

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	**# of Stocks Covered**	**% of Stocks Covered**	**Banking**	**No Banking**
Buy	43	25%	2%	98%
Long-term Buy	35	20%	0%	100%
Neutral	89	52%	7%	93%
Underperform	4	2%	0%	100%

As of 6 November 2009

Other Disclosures

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