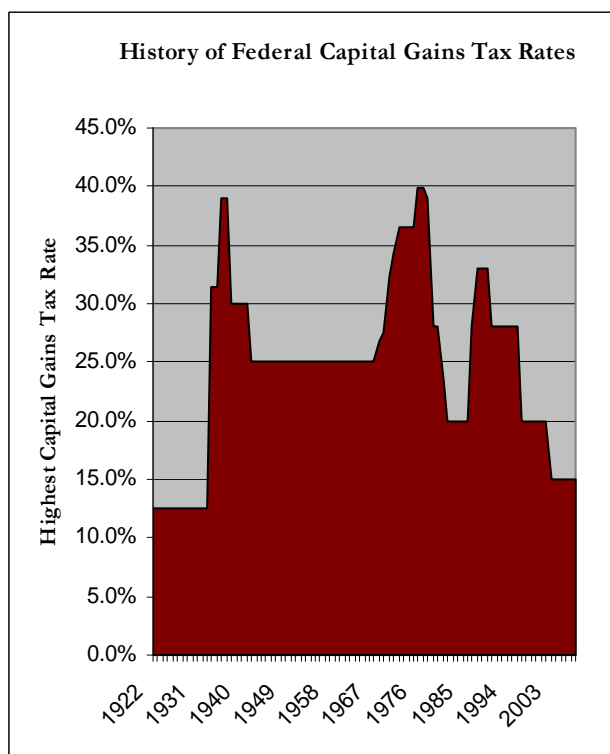


The Investor's Tax Landscape

In 2003 the Federal tax rate on long-term capital gains was temporarily reduced to 15%, the lowest capital gains rate since the early 1930s. Unless the current law is changed, the Federal rate will return to 20% on January 1, 2011. Some in Washington have called for a capital gains tax rate increase before 2011. Others have said that the rate should move to 28%. While anticipating legislative changes is a professional sport that is generally best left to Washington insiders, the existing law is clear and the current inclinations of Congress strongly suggest that investors will pay a higher Federal capital gains rate in the not too distant future. In addition, a number of states that also tax capital gains may feel significant budget pressures in the next several years and as a result look to raise capital gains tax rates.



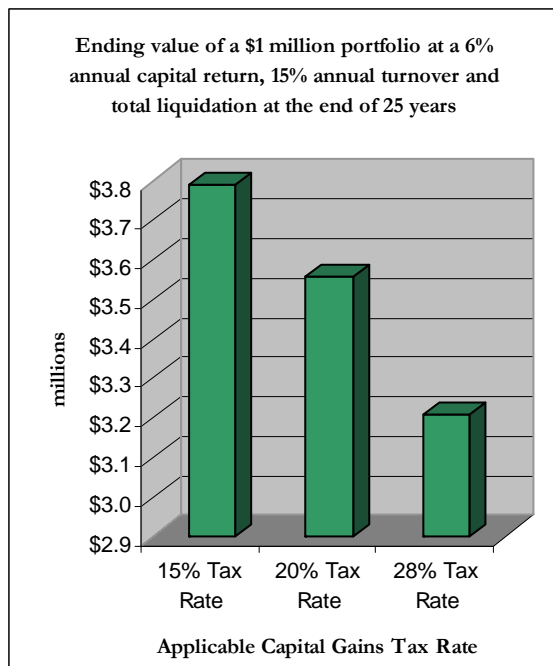
Source: Citizens For Tax Justice

The Federal tax rate on long-term capital gains has been separate and distinct from the tax rate on "ordinary income" since 1922. The accompanying graph, which has been simplified and does not indicate a number of technical exclusions and transition tax rates, shows that the current 15% capital gains tax rate is significantly lower than rates in most prior years. For example, the current capital gains rate is less than half of the highest capital gains rates payable at the end of the 1980s.

The Impact on Family Wealth Accumulation

The applicable capital gains tax rate has a major impact on the long-term ability of families to accumulate wealth. As illustrated in the chart on page 2, even with modest annual portfolio turnover, the ability to build capital over the next twenty-five years will be significantly affected if capital gains rates return to 20% or move to 28%.

With the notable exception of certain estate planning strategies, taxpayers are generally best served by delaying tax liabilities as long as possible. While the future level of capital gains taxes is not absolutely certain, it appears unlikely that the current "temporary" 15% rate will stay in place after 2010. Therefore, realizing capital gains now at historically low rates rather than later may well produce significant tax savings and help to build family wealth in subsequent years.



Other Tax Rate Changes

The same law that temporarily reduced capital gains tax rates also temporarily reduced the maximum tax rate on dividends to 15%. In addition, this law temporarily reduced tax rates on ordinary income and Federal estate tax rates. Unless the existing law is changed, on January 1, 2011 investors will once again pay taxes on dividend income at the same rate as ordinary income (28% to 39.6% for most Birch Hill clients). This is a substantial tax increase for most investors. For example, an investor with a \$2.5 million equity portfolio that produces \$50,000 of annual dividend income currently pays federal taxes on that income of \$7,500. Assuming a 2011 Federal ordinary tax rate of 36% (for taxpayers with about \$200,000 of annual income), the tax on the investor's dividend income will more than double to \$18,000.

The most extreme portion of the 2003 law temporarily reduces and then, for a twelve month period, eliminates Federal estate taxes. In 2002 the first \$1 million inherited by a non-spouse was exempt from estate taxes. The balance was taxed at a 50% rate. (Spouses may inherit an unlimited amount without paying current estate taxes.) The 2003 law increased the exemption and decreased the tax rate in several steps. In 2008 the exemption is \$2 million and the tax rate is 45%. In 2009 the exemption moves up to \$3.5 million and the tax rate is unchanged at 45%. Under the existing law, the Federal estate tax is repealed in 2010 so that no estate, no matter how large, will incur an estate tax. On January 1, 2011 the exemption reverts to the 2002 level of \$1 million and the tax rate moves up to 55%. Many observers believe that there will be substantial efforts to pass new legislation prior to the end of 2009 in order to avoid the scheduled twelve-month elimination of the estate tax.

Conclusion

It appears highly likely that Federal tax rates applicable to capital gains and common stock dividends will increase in the next several years. Higher tax rates impact the ability of families to accumulate wealth. The coming increase in capital gains rates suggests that long-term investors should consider accelerating the realization of capital gains into 2008 and possibly 2009 and 2010 if the law does not change in the interim. Such an acceleration may result in significant longer-term tax savings.

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The Principals of Birch Hill believe that all taxable investors should strive to achieve a profitable balance between tax minimization and attractive long-term investment returns. While we strive to stay current on tax-related changes we are not tax experts. You should always consult your attorney or tax advisor before making tax related decisions.