Some Tax Losses Are More Valuable Than Others

You've got to hand it to Congress, and you might as well, because they will take it anyway. Once again in an attempt to engage in a combination of rewarding some politically favored constituencies and righting previous wrongs they have proven the Law of Unintended Consequences to be as durable as the law of gravity. It is more interesting, too.

Let me state my opinion on all of these different tax rates once again: Income's income. Its source is irrelevant economically when the time comes to spend it, save it or give it away, and those are your only choices unless you intend to have it buried with your mummy in a pyramid for use in the afterlife. You cannot find anyone, anywhere, who can give you a coherent explanation as to why we should reward investments held for more than one year with a lower tax rate, and if you cannot explain something, don't do it.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (go back and check the actual names of tax laws. They call them everything but the Birds Will Sing and Flowers Will Bloom Act of 1968) made the tax rate on dividend income lower than that for short-term capital gains. The respective top marginal rates are now 15% for qualified dividends and long-term capital gains, and 35% for short-term capital gains.

The implications of this rather momentous decision have been discussed for a large number of financial instruments. For example, dividend-paying stocks are now more competitive with municipal bonds, generally exempt from federal taxation, and with passthrough vehicles such as real estate investment trusts. In addition, corporations now have an incentive to shift the total return to their investors from capital appreciation to dividends. This shift has implications for corporate governance as well given the reliance of most managerial option incentives on the stock's price as opposed to its total return.

Let's turn to the effects of the new law on security futures, also called single stock futures. This is still an emerging market that, sad to say, many of you have yet to try. Get out there and give these versatile instruments a go: No one remembers their second time.

Security Futures Basis

The fair value of a security future is the stock's price plus its interest rate cost of carry minus the future value of the expected dividend. As the dividend payout rises, the discount of the future to the stock price deepens. This used to provide a significant advantage for long security futures relative to their underlying stock; the accrued basis for contracts held for more than one year would be taxed at the long-term capital gains rate, while the dividend was taxed at ordinary income rates. Under the old law this rate held an advantage of 20% taxation as compared to as much as a 38.6% rate for ordinary income.

Despite the fact that no dividend is taxed now at a rate greater than any capital gain, capital gains retain an implied option for tax timing within a portfolio. The gains on a given position can be offset by losses elsewhere up to a combined loss of $3,000 per year before they must be carried forward into succeeding years. The losses on security futures can offset taxable gains elsewhere.

Taxes create trading opportunities but, unfortunately, are never simple. If you own a dividend-paying stock and sell a short future against it, your dividends will be taxed at 15%, while the short future will incur a short-term capital loss that can offset the 35% tax liability of other short-term capital gains. This will hold unless the stock's price decreases in price by more than the original basis, (the difference between the stock's price and the future's price) at which point the short future will show a short-term capital gain.

If you retain the losing stock position - and we all know how easy that is to do - the gain on the short future will be taxed at 35% unless offset by other losses. If you deliver the stock against the short future, you have no net economic loss on the hedged position, but dividend received will be taxed at 15%. This could be significant if dividend yields become competitive with bond yields, which are taxed as much as 35%.

If the situation is reversed, a short position in a dividend-paying stock will generate an ordinary income offset for the dividends paid by the short seller against the short-term capital gain potential for the dividend embedded in the basis. Since both positions are taxed at the same top rate of 35%, there are no differential tax rates to arbitrage unless you are long a fifth-quarter contract. This contract is eligible for a 15% long-term capital gain rate against your dividends paid, which creates a tax arbitrage.

Capturing The Tax Difference

The fair value of any future has a no-arbitrage band around it defined by transaction costs, different borrowing and lending rates and other considerations. The new tax law widens this band for security futures. A dividend is now [(1-.15)/(1-.35)], or 1.308 times as valuable as a short-term capital gain after taxes, barring portfolio offsets. A holder of a dividend-paying stock should not sell a future against it until it has risen [.308*dividend] in price. Similarly, the buyer of a future for expiration in less than one year needs to lower the bid by [(1-.35)/(1-.15)], or [.765*dividend] to compensate for the tax differential.

A buyer of a fifth-quarter future, in the trade discussed above, wherein the embedded dividend is turned into a long-term capital gain taxed at the same 15% rate as the dividend does not need to adjust the bid downward. So, if you are wondering how to get your feet wet in the security futures market, and you would like to have your 38.6% income reduced and your 15% income enhanced with no economic risk, here's the trade for you. Go short a high dividend stock like Altria Group and buy the June 2004 future.

And then hope they cut the dividend to reduce your quarterly liability on the stock. The original dividend will remain embedded in the future's basis.