World Turned Upside Down

Whether the British army surrendering to George Washington at Yorktown on October 19, 1781 - a mere 206 years before the stock market crash of 1987 - actually played the march "The World Turned Upside Down" is subject to immaterial debate. Marie Antoinette probably never uttered the one line for which she is remembered, either, but the story endures.

One consequence of the recently enacted Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, catchy name for a law, no?) was to tax dividend income at a rate lower than that of short-term capital gains. The respective top marginal rates are now 15% for qualified dividends and 35% for short-term capital gains. This decision turns many aspects of investment planning upside down, especially for the still-emerging world of security futures, although one suspects this latter topic was not foremost amongst legislative considerations.

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. Corporations may now have an incentive to shift the total return to their investors from capital appreciation to dividends, which will affect the economics of the growing equity total return swap business. 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.

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% as compared to as much as 38.6% for ordinary income. Under the new law, short-term gains, those that apply on contracts held for less than one year, are taxed at ordinary income rates as high as 35%, while both dividends and long-term capital gains are taxed at 15%.

Though no qualified 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.

Payment In Lieu

If you go short a dividend-paying stock, you must make a payment in lieu of the dividend to the stock's lender. The short seller's payment in lieu gets capitalized into the price basis of the sale. If, for example, you sell a stock short at $50 and it pays a $1 dividend, your sale price will get adjusted downward to $49. This will either lower your short-term capital gains liability or increase your short-term capital losses, depending on your overall situation.

If the short sale is paired with a long security future held for more than one year, and the price of the stock does not fall by more than the basis discount, the long security future will show a long-term capital gain taxed at 15%. This pairing of a short-term loss and a long-term gain can create tax advantages. If the stock falls in price, the short stock position will produce a short-term capital gain and a long-term capital loss. Depending on your overall portfolio, that can be disadvantageous.

Prior to JGTRRA, payments in lieu and the dividend both were taxed at the same rate, and the lender was therefore indifferent. Starting in 2004, the stock's lender will need to forego a 15% tax and accept an ordinary income tax, and if that does not provide an additional incentive to go short with security futures, nothing does.

Dividends Received And Offshore Investing

The long stock / short future situation has its own complexities. The dividend most always will be taxed as ordinary income, the future falls under short-term rules, and the stock can be taxed under long-term capital gains if held past a year.

Finally, the expected increase in dividend payouts affects non-U.S. investors subject to dividend withholdings of 30% of the dividend amount. These withholdings cost the investor the present value between the dividend payment date and the tax credit date following the end of the tax year. Many such investors have experimented with swapping the stock for the security future before the ex-dividend date and after the payment date to sidestep this withholding.