Security Futures Tied To Dividend Whipping Post

Cynics seldom are disappointed about the course of human events. This past August I wrote a column summarizing the labyrinthine tax treatment of single stock futures (SSFs) in which my concluding line was:

> At least we can take solace that once tax law is written, it's pretty much left alone, isn't it?

Ha! Not even five months later, the administration decided to take me up on the deal and propose a set of tax changes that will have some truly profound impacts on all of our investments. In general, I applaud the President's proposals and will continue applauding until my own little vision of a tax utopia (how's that for an oxymoron?) is reached. Specifically, I propose:

1. A complete elimination of the corporate income tax. Corporations do not pay taxes, they collect taxes. The tax is paid by shareholders, employees, customers and suppliers in proportions that vary widely from company to company and from industry to industry. Moreover, it is hugely expensive to administer, and invites the sort of chicanery that produced the Enron/Worldcom/Andersen fiascoes;
2. Full deductibility of losses from ordinary income. The $3,000 limit on loss deductibility against the full taxability of gains does not pass the fairness standard of a children's playground;
3. Complete elimination of capital gains taxes, or at the very least, elimination of the economically meaningless distinction between long- and short-term gains. Income's income regardless of its source or how long it took to produce, and if we are going to tax asset appreciation, let's at least adjust it for inflation and tax it as ordinary income;
4. Failing passage of Point 1 - and I'm not holding my breath - end the double taxation of dividends not at the individual level, but at the corporate level. This will treat the costs of debt and equity capital consistently for the corporation. As an aside, the two forms of capital can never be treated equally as they represent different risks and claims legally.

The Effects on Security Futures

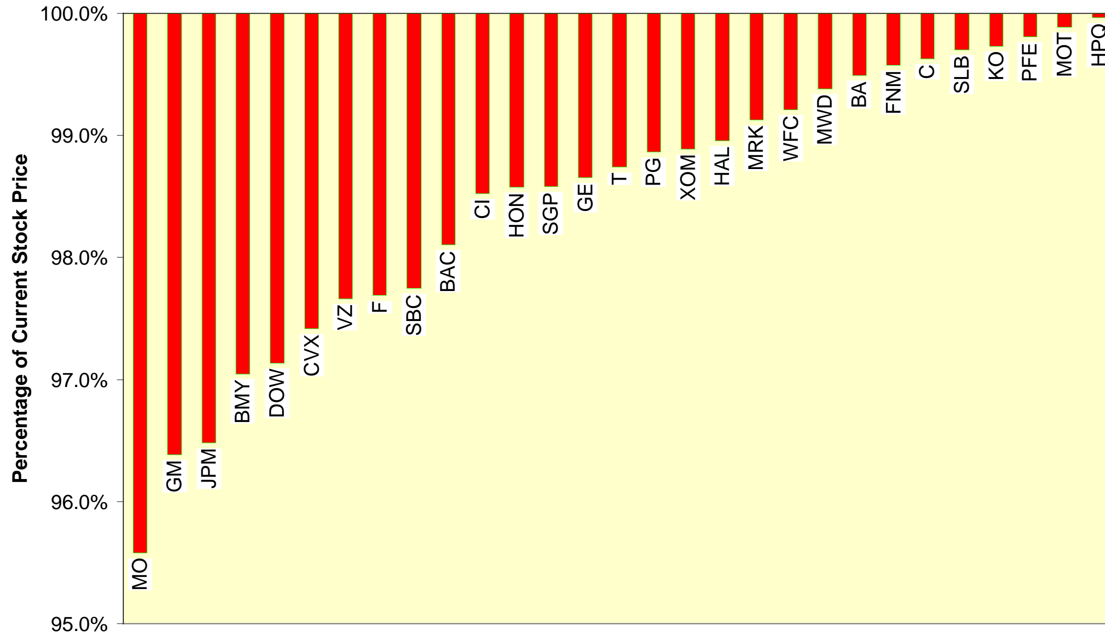
Taxes affect behavior and create trading opportunities. As I am sure many of you have done as well, I have tried wherever possible to stuff my tax-advantaged accounts with higher-yielding instruments. If the dividend tax is in fact eliminated - the betting here is that it will be reduced, but not eliminated entirely - then putting high-yielding stocks in a 401-K or an IRA is as irrational as putting municipal bonds therein.

At zero-taxation and if we add in the increase in cost basis that will serve to reduce capital gains taxes, (retained earnings not paid as dividends will be added to the per-share cost basis) dividends will have an advantage with respect to both bond interest and capital gains. This may not be as socially upsetting as changing the rules of poker so that two pair now beats three of a kind, but it is of the same magnitude. You will have to learn new ways of thinking, and who wants that?

The still-new business of SSFs will be affected as well. The price of a stock future is the price of the stock plus the interest rate cost of carry minus the future value of the expected dividend. If the dividend yield is higher than the short-term interest rate, as is almost always the case at today's 1.20% T-bill rates, then the SSF will trade at a discount to the stock. This discount accrues to the capital gain or loss on the stock until expiration.

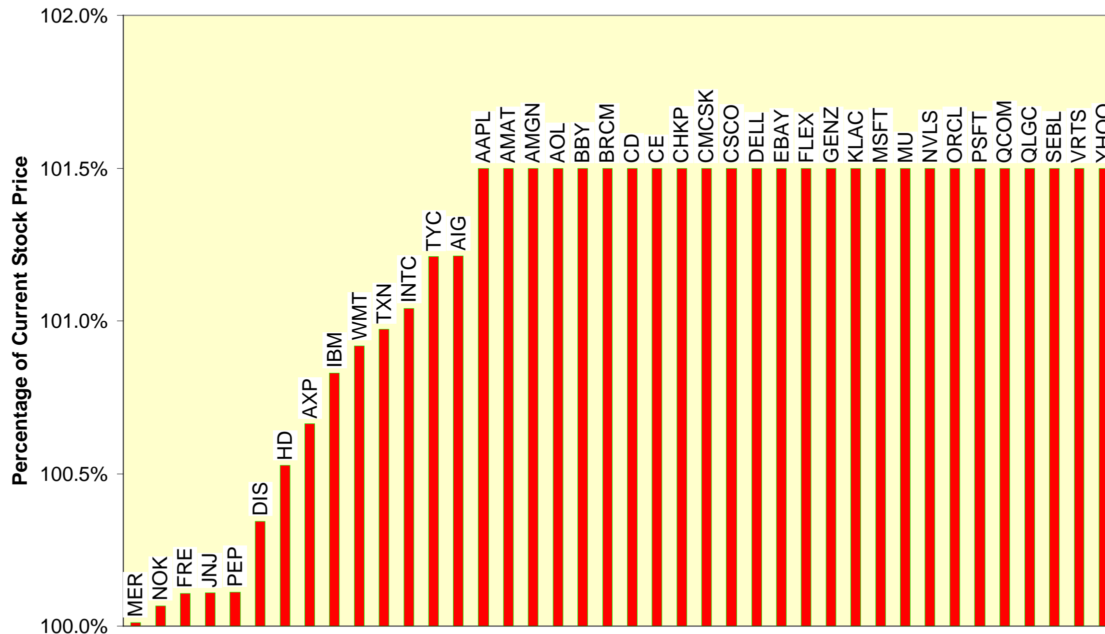
At the one-year horizon, where interest rates are close to 1.5%, we should expect to see the SSFs of stocks yielding more than 1.5% trading at the discounts in the chart below.

**Fair Value Multiplier At One-Year Horzion:
High-Dividend**



Stocks that do not pay a dividend at all or whose yield is less than 1.5%, will see their future trading at a premium to the stock.

**Fair Value Multiplier At One-Year Horzion:
Low- Or Zero-Dividend**



The Critical Dividend Yield

If the long SSF position on a dividend-paying stock was profitable, the ordinary income of the dividend was converted into the appropriate capital gain. If the long position lost money, the accrued dividend got buried in the capital loss, a distinct advantage to those infuriating situations when you have to pay dividend taxes on a money-losing stock or mutual fund. In either case, being long the SSF of a dividend-paying stock was preferable from the dividend taxation point of view to owning the stock.

At zero-taxation, a profitable long position on a dividend-paying stock will always have an advantage over a profitable long SSF. The stock's dividend will be tax-free and the cost basis of the stock will be adjusted higher for capital gains purposes, while the SSF's capital gain will be taxed at the appropriate capital gains rate and no adjustment in cost basis is contemplated at present. Of course, capital gains on SSFs can be offset by losses elsewhere

For short positions, the outcome is different, even in ways different than the interest rate differentials described in a previous article. The seller of an SSF on a high-dividend stock pays the (dividend - interest rate) on the stock over time in the form of the same accrual noted above. A short SSF on a dividend-paying stock whose price declines by less than this (dividend - interest rate) amount, adjusted for ex-dividend trading, over the life of the trade will lose money and throw off a short-term capital loss than can be used to offset gains elsewhere. This is the critical dividend yield; should the stock fall further a short-term capital gains tax liability can be created.

Hedging

If this short SSF is combined with a long position in the stock, a classic hedge that is margined at only 5% of the current market value if the SSF is held in a securities account instead of a futures account, a tax arbitrage appears.

Let's take General Motors and its 5.11% yield. On January 10, the stock settled at $39.11, and a June 2003 future settled at $38.31, virtually at its fair value given a 1.25% interest rate. If GM does not move between now and June 20, the seller of the future will lose $0.80. The holder of the stock should receive two $0.50 quarterly dividend payments. The remaining $0.20 is the interest rate differential paid by the GM holder. We should expect a drop of $1.00 in GM's price to reflect the dividend payouts; this will benefit the short future and hurt the long stock. Prior to tax treatment, everyone is equal.

But after taxes, you win: The $1.00 in dividends is yours tax-free and you deliver the GM stock against the short June 2003 future at $38.31 for a $0.80 short-term capital loss. Your risk in the trade is that GM will slash its dividend by more than $0.10 per quarter.

So long as the June 2003 future can be sold for any amount over $38.11, the tax arbitrage remains open. If traders start piling onto the long stock / short SSF trade, we could see the forward curve for SSFs invert, with June trading below $38.11. How low could it go? The marginal buyer with a 38.6% short-term capital gains rate would need to pay ($38.31 - ((1-.386) * $0.80)), or $37.82, to achieve complete parity with the long stock owner.

I haven't examined all of the other implications of the Bush tax proposal yet, but I'm pretty sure they're as equally straightforward.